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# P r e f a c e

Marketing is an important function in modern business and, hence, a major area of managerial responsibility. Today's students of business administration are tomorrow's business decision-makers and so must learn how to analyze and find solutions for problems in this important area. Marketing decision-makers must first recognize that marketing involves certain basic activities, directed toward the common goal of matching products to markets, and carried on by different institutions. Part One provides this necessary orientation to the marketing field. Marketing decisions are affected by and made within an environment made up of diverse and ever-changing economic, psychological, sociological, and political factors, and this environmental setting for marketing decision-making is surveyed in Part Two. The marketing decision-making process itself—i.e., the gathering and analysis of marketing information, the measurement of markets, and the formulation of alternatives—is analyzed in Part Three. Marketing decisions pertaining to organization, products, prices, channels of distribution, physical distribution, promotion, and strategy are discussed and analyzed in Part Four. This coverage reflects our belief that a basic marketing book should concentrate neither on functions and institutions nor on the areas for management decision—the marketing con-

trollables. We believe that functions and institutions and the areas for management decision are both important, but we also believe that the environment for decision-making and the decision-making process itself are at least as important and should be included in the basic marketing course.

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# PART ONE

# ***Some Basic Concepts***

INTRODUCTION

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# INTRODUCTION

# 1

Except for occasional hermits, few people are completely self-sufficient. Most people have to satisfy all their material wants through outside sources, and, in satisfying these wants, find that they must take part in various activities incident to obtaining needed goods and services from outside sources of supply. As consumers, people perform some of these activities themselves. For example, they shop for the goods and services they need. They read and listen to advertisements (and talk with sales people, look around stores, and do window shopping) to find out what is available in which quantities at what prices. And they are continually deciding among stores, products,



brands, and models. Again as consumers, people are the "targets" of many activities performed by business people such as those who devote their time and efforts to getting information to them (e.g., advertisements), researching them to obtain information from them (e.g., on the likely marketability of some new product), getting the goods and services to them, and, ultimately, "selling" them. The result of these consumer-performed and business-performed activities is a flow of goods and services from producers to consumers.

### DEFINITION OF MARKETING

Marketing, according to the American Marketing Association, consists of the performance of business activities that direct the flow of goods and services from producer to consumer or user.<sup>1</sup> Although this definition of marketing is the one most generally accepted, we will use a different definition in this book. In our view, *marketing is the business process by which products are matched with markets and through which transfers of ownership are effected*. Why we have chosen to use this definition will be made clear in the discussion that follows.

### Product-Market Interrelationship

We believe, first of all, that the interrelatedness of *product* and *market* is an essential idea and should be included in a definition of marketing. So our definition states, in part, that "marketing is the business process by which products are matched with markets." The notion we want to convey here is that marketing and production activities are interlocked—that these two major business functions (namely marketing and production) certainly depend on each other, since we can only market products which can be produced, and we should only produce those that can be marketed. Thus it is logical to think of marketing as the business process by which specific products are matched up with specific markets, while thinking of production as the business process concerned with manufacturing these products.

We must, however, recognize that most companies do not manufacture products which fit markets exactly, this happening only in the comparatively rare instances where products are made to order for individual customers. For most companies, precise fitting of products to markets is extremely difficult, if not wholly impossible. One important reason for this is that although markets are usually made up of large numbers of present and prospective customers who have some needs in common, each of them may have rather individual ideas as to the characteristics a product should possess. Another important reason is that a company must stand-

<sup>1</sup> Committee on Definitions, *Marketing Definitions* (Chicago: American Marketing Association, 1960), p. 15.

ardize certain product characteristics if it is to take economic advantage of mass production methods. However, the products manufactured should still be attractive enough to ultimate buyers so that sales will be large enough to return adequate profits. Accordingly, management usually decides on products with characteristics falling somewhere between what individual consumers most generally prefer and what can be produced at the lowest unit cost. In other words, the problem here is both one of marketing and of production: it is to select, manufacture, and market products which possess as many as possible of those characteristics considered desirable by large numbers of customers and prospects (i.e., by those who make up the "markets") and to do this with as little sacrifice of manufacturing economies as possible.

Top-management bears the ultimate responsibility for solving this problem, but marketing management plays a large role in the solution. Marketing research uncovers the product characteristics wanted by final buyers in various markets, and top-management (working with both marketing and production executives) translates these wants into product specifications. Where products have been developed through technical research carried on within the company, marketing research is used to find and measure potential markets. Thus, ideas for products may come either from the markets or from inside the company itself, and marketing research is useful in both instances. Through skillful application and combination of what we will call the marketing "controllables" (e.g., pricing, advertising, and personal selling), marketing management may stimulate or even "create" markets for old as well as new products. Ordinarily, these adaptive strategies (that is, attempts to bring products and markets together) are combined: some product specifications are established after marketing research learns what the market wants and expects, a search is carried on for likely markets for new products with features derived from technical research, and various marketing controllables are manipulated toward the end of gaining and holding market favor for both new and old products. The success of the total enterprise, measured in terms of income and long-run growth, depends not only on the efficiency with which marketing and production activities are performed but, as we have just seen, on the skill and effectiveness with which these two sets of important business activities are blended. So it is no accident that modern management regards marketing and production as interdependent business functions. Nor is it an accident that modern management thinks of marketing as the business process by which specific products are matched up with specific markets, and considers production the business process responsible for manufacturing these products. These two major business processes are inseparable, and management certainly can ill afford to think of them otherwise.

### **Ownership Transfers**

Ownership transfers occur repeatedly as products flow from producers to consumers. For instance, a manufacturer may sell his output to wholesalers who, in turn, resell it to retailers who, again in turn, resell it to consumers. In this instance, every unit of the manufacturer's product that is finally purchased by a consumer has had its ownership transferred three times (manufacturer to wholesaler, wholesaler to retailer, retailer to consumer). Notice that for a transfer of ownership to take place, buying as well as selling is necessary. Notice something else about this simple example: in moving a product to market, the producer only sells, the resellers (wholesalers and retailers) both buy and sell, and the consumer only buys. Consumers, as we noted before, are the "targets" of marketing activities—the whole flow of goods and services from producers to consumers anticipates this final buying action by consumers. All the selling and buying transactions that occur up to the time that the product is made available for consumer purchase are preliminaries. Only when that last buying transaction by a consumer in the sequence of selling-buying transactions takes place can the last selling transaction (by a retailer) occur. There can be no marketing, then, unless transfers of ownership are effected. Therefore, we have included this point explicitly in our definition of marketing.

### **Summing Up**

We believe, then, that marketing may best be described in terms of product-market interrelationships and of ownership transfers. Marketing management seeks to match up goods and services with markets, and to effect transfers in the ownership of these goods and services. Consequently, in our view, *marketing is the business process by which products are matched with markets and through which transfers of ownership are effected*. The business process of marketing, then, includes all those business activities involved in moving goods and services from manufacturers and other producers to final consumers and users, plus those activities involved in evaluating these markets and adjusting product characteristics to market needs.

### **MARKETING AND SOCIETY**

In any society, patterns of consumption are directly affected by and dependent on the structure and the efficiency of the marketing system. By a "pattern of consumption" we mean not only how much of what kind of goods and services are made available for consumption, but also how much of these goods and services are actually consumed and in what manner. By "structure of the marketing system" we mean the whole network of marketing institutions which serves society's needs. At one end

of this network, producers initiate the flow of goods and services, and various intermediaries (e.g., wholesalers and retailers) maintain this flow, finally discharging the goods and services for consumption and use. "Efficiency" here refers to the value added to goods and services through the performance of marketing activities. Generally speaking, marketing adds value to goods by changing their ownership and by changing their time and place of consumption. For example, Idaho potatoes at harvest time are of less value to the grower than they are three months later (change of time) after they have been shipped and received in Pittsburgh (change of place), and when they are finally bought by a restaurant owner (change of ownership).<sup>2</sup> Marketing adds value to services (e.g., legal, medical, entertainment, and educational services) by performing the services involved. A lawyer, for example, applies his specialized knowledge and experience in helping clients solve various legal problems, and his fees represent value added through performance of legal services. Similarly, the retail store that provides credit facilities for its customers (making it possible for customers to take possession of their purchases now and to pay for them later) adds value to the extent that customers take advantage of their credit privileges. Patterns of consumption, then, are determined both by the structure of the marketing system which is set up to carry the flow of goods and services from producers to consumers and users, and by the value added to these goods and services through performance of marketing activities. Undoubtedly, this is what Paul M. Mazur, a New York investment banker, had in mind when he referred to marketing as "the delivery of a standard of living."<sup>3</sup> To grasp the full significance of Mr. Mazur's comment, however, we need the further analysis provided in the sections that follow.

### *The Standard of Living*

The standard of living refers both to the actual pattern of consumption of goods and services and to the manner of living. The structure and efficiency of the marketing system strongly influence the pattern of consumption, but have only a limited influence on the manner of living (i.e., on the manner in which goods and services are consumed). Differences in the manner of living are caused by such things as family and class traditions, educational and cultural influences, and social pressures of membership in

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<sup>2</sup> To be sure, non-marketing operations also add value to Idaho potatoes. Certainly the mature tubers which are dug out of the ground are worth more than the seed potatoes put into the ground (value added through planting growing, and harvesting); and the restaurant workers, as they scrub, bake, and otherwise prepare this food item for diners' eating pleasure also add value. These, however, are instances where value is added to a product by changing its *form*—in other words, adding value by operations more akin to manufacturing than to marketing.

<sup>3</sup> P. M. Mazur, "Does Distribution Cost Enough?" *Fortune*, Vol. XXXVI, No. 5 (November 1947), p. 138.

different groups. Different combinations of such causes result in different manners of living, even though the particular goods and services consumed may be the same. Under one standard of living, for instance, food may be prepared expertly and served elegantly (with linen, fine china, silver, by candlelight), while under a second standard of living, the same food may be poorly prepared and served in a most unattractive manner (perhaps on a bare table top and dished up in tin plates) <sup>4</sup> Even though the marketing system has only a limited influence over the manner of living, marketers must, in making decisions, take into account those sociological and other variables that cause different people to have different standards of living. If they are to shape the actual pattern of consumption, marketers must take these variables into consideration as they manipulate such marketing controllables as price, advertising, and personal selling. The end results of such manipulations are reflected in changes in consumption patterns, and, in this way, marketers participate in the delivery of a standard of living.

#### *Economic Determinants of the Standard of Living*

Marketing, of course, is not the sole economic determinant of the standard of living. It is, however, one of the triumvirate of important economic determinants—production, purchasing power, and marketing—affecting the standard of living. Too often, businessmen and other economic observers have contended that some one of these three is the key to all problems concerning the standard of living. The fact is that any standard of living is economically determined by an interaction of production, purchasing power, and marketing. Consumption, of course, is limited by production, since goods must first be produced before they can be consumed. Similarly, consumer purchasing power (combined with the propensity to consume) is necessary if production is to be converted into consumption.

In the past, the conventional way of looking at marketing was to consider it as merely the means through which production and purchasing power were converted into consumption. Thus, production and its derivative, purchasing power, were considered the really important economic forces, and marketing was thought of as playing the necessary but secondary role of allocating the outputs of the nation's factories, mines, farms, forests, and fisheries to those who consumed these outputs. This view was a great deal more valid in the past than it has been for about the last half century; to understand why, it is helpful if we review the relative impact of production, purchasing power, and marketing in various stages of economic development.

<sup>4</sup> This illustration adapted from: P. H. Nystrom, *Economic Principles of Consumption* (New York: Ronald Press, 1929), p. 245.

**ECONOMIC DEVELOPMENT AND THE STANDARD OF LIVING.** Both the combined and the relative impact of the three main economic-determinants—production, purchasing power, and marketing—vary with the stage of a country's economic development. Take the United States as an example. During the early phases of its history, production was cast in the key role. In the period of initial colonization, however, production was directed mainly to the exploiting of the country's vast natural resources—fertile land, abundant forests, rich mineral deposits, readily accessible water power, and the like. Little in the way of manufacturing facilities existed, except for occasional water-wheel powered grain mills, back-country whisky stills, and other primitive operations. This situation continued without much change up to the eve of the American Revolution, when the need to supply the revolutionary forces and to partially compensate for lost imports gave impetus to the building of manufacturing facilities—e.g., gunpowder plants, musket factories, textile mills, and ship-building yards. Both before and after the Revolution, and especially with the great westward push of the pioneers, there were severe manpower shortages and these accounted not only for the introduction and prolonged use of slaves, but for the development of production methods capable of turning out more goods with less human labor than had ever before been thought possible. But even though quantities of most goods were usually smaller than the quantities that were needed, wages and profits were relatively high, and consumer purchasing power rose continually. For these reasons, disposing of the country's output was not very difficult, and marketing presented no great problems.

During most of the nineteenth century and well into the twentieth, market demand for most goods was usually far in excess of what the country could produce. Successive waves of immigrants arrived and added to this strength of market demand, even before they were absorbed into the nation's labor force. The imbalance of demand with supply was added to by the economy's need to pay off debts to European creditors, debts incurred in connection with both the financing of new production facilities and the westward frontier expansion. As is still typical in today's developing economies (e.g., Colombia, Venezuela, Indonesia, and Ghana), limited domestic investment capital was available, and it was necessary to attract foreign capital to finance many, if not most, of the nation's railroads and early manufacturing enterprises. Through the mechanisms of international trade, the economy paid its installments on these debts at first in the form of raw materials (e.g., cotton, tobacco, and lumber) and later in the form of exports of manufactured goods. Because the country's productive capacity was used not only to supply a fast-growing domestic market but to

satisfy claims of foreign creditors, there was almost continuous pressure to further expand production.

Throughout the nineteenth century and into the twentieth, U.S. population grew rapidly but remained small relative to industry's needs for labor. This put, as we said earlier, a premium on the devising of ways to economize on the use of manpower in production. But, at the same time, even though the manpower shortage persisted, the domestic market was growing, too, and there were increasing numbers of people with high *real* incomes (i.e., high in terms of actual purchasing power). Since their dollar incomes rose faster than prices, most consumers were able to buy more and more goods—in other words, consumer purchasing power was still rising. Even though there was still pressure on the country's productive capacity, American production ingenuity was not to be denied, new ways were found to step up factory outputs, thus hurrying the day when some parts of this productive capacity would eventually exceed market demand. But the important point to note here is that real incomes (i.e., actual purchasing power) rose faster than money incomes, thus making possible a continued strong upward thrust in the American standard of living.

After the Civil War, the rise of trade unions and the growth of social legislation brought about a reduction in the average work week from as much as sixty or seventy hours to forty hours or even less. Working conditions, at the same time, were constantly improving and the general level of education was rising. These trends left the worker with an increasing amount of leisure time and a far less exhausted body and mind with which to enjoy it.<sup>5</sup> Since workers, along with most everyone else, possessed increasing amounts of purchasing power, they also had the financial means with which to buy what we know today as "leisure time" goods and services (e.g., hunting and fishing equipment, sporting goods, and movie and theater tickets). These trends served, then, to add further strength to market demand, but they called for the development and production of new products as much as they did for continued expansion in the output of established products. Large segments of the American consuming public were looking for goods and services with which they could occupy their increasing leisure time. They were, in effect, developing new "wants."

**EVOLUTION OF MARKETING.** Nineteenth-century marketing systems developed almost as by-products of the systems used for production. The main problem continued to be that of producing enough, and the main marketing problem remained simply that of moving goods from points of production to points of consumption. When markets in and near the industrial towns could no longer absorb their particular factories' output,

<sup>5</sup> Mazur, "Does Distribution Cost Enough?" p. 197.

"drummers" (i.e., traveling salesmen) were put on the road to obtain orders from more distant markets and itinerant peddlers in their horse-drawn buggies moved from town to town (buying their stocks in one place and selling them in the next). Then, too, wholesale institutions, active in towns along the Atlantic Seaboard since colonial times, began appearing in inland population centers and, by the end of the Civil War, wholesalers were well established in larger towns and cities everywhere. In retailing, frontier trading posts gave way first to country general stores and later, with the growth of population centers, to more specialized grocery, hardware, feed and grain, and other retail stores. In the cities, especially after the Civil War, department stores opened and the first chain-store systems were being organized. To serve the still-large and far-spread farming and ranching population, the first mail-order houses began operations. Manufacturers still considered production their main problem, and left practically all of marketing to the country's wholesalers and retailers.

By the early twentieth century, however, it was increasingly clear that the nation's network of marketing institutions served as an important mechanism by which the products of different industries located in different places were exchanged among different market areas. This mechanism made possible area specialization of production (e.g., textiles in New England, meat-packing in Chicago, citrus growing in Florida and California, lumbering in the Pacific Northwest and later, automobile manufacture in Detroit, flour-milling in Minneapolis, and shoes in St. Louis) and helped, consequently, because of mass production economies, to achieve lower costs of production. The same marketing network performed the function of making the geographical dispersal of consumption possible. New Englanders could now enjoy citrus fruit grown in Florida and California, and Californians and Floridians could readily buy textiles produced in New England. Thus, with the passing of every year, more goods were being made available to more people, and the "self-contained, self-sufficient" community passed out of existence. With the development of both production facilities and marketing outlets from one end of the country to the other, with each area tending to specialize in producing what it could produce best, and with marketing outlets everywhere selling the product of all areas, the world was witnessing the birth and growth of the first great modern "common market"—i.e., the American common market.<sup>6</sup>

<sup>6</sup> The Roman Empire, of course, provides a well-known example of an ancient "common market." Very close commercial relations existed among all the Roman territories bordering on the Mediterranean Sea. Professor Henri Pirenne, for instance, in referring to the late third century, notes that "both manufactured and natural products were . . . extensively dealt in: textiles from Constantinople, Edessa, Antioch, and Alexandria; wines, oils and spices from Syria; papyrus from Egypt; wheat from Egypt, Africa, and Spain; and wines from Gaul and Italy." See: H. Pirenne, *Medieval Cities* (Princeton: Princeton University Press, 1925), Doubleday Anchor Edition, p. 2.



The manner in which American marketing evolved was strongly influenced by what has been called the greatest sales promotion (as well as political) instrument ever forged—the revolutionary doctrine that “all men are created equal.”<sup>7</sup> Unlike much of Europe and most other parts of the world, where elaborate systems of social stratification kept people rigidly in their places, the United States early adopted an almost universal democracy of the marketplace. Americans, regardless of their social class, have not been restricted as to the goods and services they have a “right” to consume. What the richest and most aristocratic members of society consume, members of lower classes also have the right to consume—or at least to want to consume. Not everyone has the money to buy an ocean-going pleasure craft, but we all have the *right* to want one. What a wealthy woman wears on New York’s Fifth Avenue on Easter Sunday, every working girl has the right to want and to buy, if not the designer’s “original,” then at least an imitator’s copy. This doctrine that everyone is equal, or at least starts out equal, has been a prime factor in making mass markets for many products possible. And these mass markets, in turn, have made mass production also possible. Such democracy in the marketplace has, for example, turned the making of golf clubs from a handicraft operation into a mass production industry—once the sport of only the “upper crust,” golfers today are numbered in the millions.

Mass markets for most products did not, of course, develop spontaneously, but were stimulated and, in many cases, even “created” through marketing effort. Personal selling, advertising, and other marketing devices have all played important roles. Personal selling’s main role has been to effect ownership transfers (through multiple levels of middlemen) and to assure that final sales to consumers are consummated; advertising’s main role has been to inform the buying public of what is available and to motivate them to buy. In moving goods through distribution channels (i.e., from producers to consumers) personal selling’s function has been to “push” and advertising’s function has been to “pull.” These basic push and pull marketing strategies, which are usually used together rather than singly, have been backed up by marketing research, product development and improvement, pricing, dealer organization and cooperation, and physical distribution of the goods themselves. And the basic push and pull strategies have been supplemented through the evolution and imaginative use of such devices as installment credit. When limited consumer purchasing power seemed to block market expansion for such “big ticket” items as automobiles, furniture, and large appliances, installment credit came to the rescue and provided consumers with a way to augment their purchasing power by pledging future income. For many people, the size of the

<sup>7</sup> Masur, *loc. cit.*

"monthly payment" has become as important a buying consideration as the total price. Thus, in the installment credit device, marketing found a way around apparently limited purchasing power in the marketplace. The "capacity to consume" was there, and marketing used installment credit to free it. It is possible, then, to develop a mass market for a product, but only if there is the necessary capacity to consume that product, and only if marketing effort succeeds in unlocking that capacity.

Some people contend that business emphasis may shift from the present concern with marketing to finding new ways for expanding the capacity to consume. Traditional economic thinking has been that human wants are insatiable (i.e., that no matter how much people consume, they will always want more of something), but recently this thinking has been challenged. Professor Galbraith, for one, argues, in effect, that most wants of U.S. consumers would have long since been satisfied had it not been for the "manufacturing of demand" for each succeeding new product introduced to the marketplace and, he argues further, that "the fact that wants can be synthesized by advertising, catalyzed by salesmanship, and shaped by the discreet manipulations of the persuaders shows that they [that is, the wants] are not very urgent."<sup>8</sup> In the past the main problem was to produce enough to meet the needs of the market, in the present it is to market all that can be produced, and in the future it may be to find new ways for expanding the capacity to consume. There is no denying the fact that in a gradually growing list of industries, the capacity to produce has gotten larger than what the market will readily absorb, and more and more manufacturers are coming to consider marketing not only a problem for middlemen but for manufacturers as well. But this still leaves the interesting question of whether in an increasingly opulent society there might be some sort of natural limit on the capacity to consume. Professor Cox has, in the following novel way, highlighted the nature of this possible business dilemma of the future:<sup>9</sup>

The startling idea that capacity to consume may be a scarce resource has even begun to find its way into science fiction, which so often in the past has shown us at least the dim outlines of the future. The other day I ran across a story cast, as so many of these stories are, several hundred years in the future. The period is described as coming after the age of plenty. And the astonishing thing about the post-plenty era, as the author sees it in his imagination, is that its people look back to the age of plenty (toward which we strive with such eagerness) as a time of great distress and suffering. What they have escaped from, and what by inference we should try to avoid, is

<sup>8</sup> J. K. Galbraith, *The Affluent Society* (Boston: Houghton Mifflin, 1958), pp. 156, 158.

<sup>9</sup> R. Cox, "The Outlook for Costs Imposed and Values Added by Distribution," in *Report of the Twenty-Eighth Boston Conference on Distribution* (Boston: Retail Trade Board, 1956), p. 50ff.

a nightmare in which terrific social pressures force consumers to consume and consume and consume beyond the limits of human endurance in order to keep the wheels of production turning.

In this story, a great genius finally came along to rescue mankind from its awful age of plenty. He reasoned that if mechanizing production had resulted in a monstrous outpouring of goods and services too far beyond man's capacity to consume, the thing to do was to mechanize consumption. So the problem had been solved. One set of mechanical monsters made the goods; another set of mechanical monsters consumed them. The economy ran along steadily at full employment, and poor humanity could go back to its simple business of enjoying life.

Marketing men have been a little too quick, I think, to accept the responsibility set up by this philosophy for keeping consumers hungry and dissatisfied in the midst of plenty. There has always been a danger that we might fall into the absurd position illustrated by the fable I have just described, where our ideas of what the economic process is all about become strangely perverted and we really come to believe that the function of the consumer is to serve and maintain production rather than the other way around.

#### *Power of the Consumer*

As a society advances to successively higher stages of economic development, the consumer's function in the economic process becomes increasingly important. In the early phases of economic development, when production is still the main problem, the marketing problem focuses chiefly on the physical distribution of goods; consumers, as such, do not present much of a problem. But as production capacity catches up with and, in some cases, gets to be larger than market demand, increasing attention is paid to the power of the consumer. Thus, as an economy of scarcity evolves into one of plenty, business shifts its emphasis from production problems to marketing problems and, in firm after firm, marketing receives recognition as the mechanism responsible both for initiating and maintaining the flow of income into the business. The flow of business income is, of course, the result of the outward flow of goods and services from producers to consumers—a flow which marketing also initiates and maintains. The consumer becomes a force to be reckoned with—a fact obvious to retailers (they deal directly with consumers and obtain all of their income from sales made to consumers), less obvious to wholesalers (they deal with retailers, not with consumers, but their income depends indirectly, though importantly, on consumers' purchases), and probably least obvious to manufacturers, raw materials suppliers, and other primary producers (who, typically, are furthest removed from direct dealing with consumers). Sooner or later, however, all levels of distribution are forced to acknowledge that the consumer not only stands at the end of the marketing channel, but provides the spark (i.e., by buying) which

starts the chain reaction of sales and income all along the marketing channel. Marketing industry's products is no longer just a matter of selling to the next distribution level but is, in addition, one of persuading ultimate consumers and final users to buy.

In the economy of plenty, then, the basic business (and marketing) problem is one of activating consumers as individuals and as members of groups into buyers. Society as a whole becomes more consumption-oriented and less production-oriented.<sup>10</sup> Traditional attitudes about the virtues of production and the natural sinfulness of consumption, rooted in an economic philosophy inherited from the age of scarcity, are modified although not completely eliminated. Society and businessmen are literally forced to recognize that consumer behavior dominates the whole economic process (unless consumers buy, goods may back up in the marketing channel, and ultimately the wheels of production may stop turning) and, thus, at least in the eyes of businessmen, production becomes a little less virtuous and consumption a great deal less sinful.

An economy of plenty can become one of surplus. This has already occurred in some economic sectors of the United States. Greatly improved agricultural techniques, for instance, although requiring both less labor and less land, have resulted in almost terrifying farm surpluses. Even now we are at the place where as a result of technological progress (evidenced, in some cases, not only by automated production lines but by almost fully-automated factories) more and more people are being released from industrial production, and a slow transition is going on in converting their abilities to use in providing the vast quantity of services that are needed for society's further advancement.<sup>11</sup> More manpower, in other words, is being switched from the production of goods to the providing of services, which include education, government, recreation, travel, the health services, and many others which must usually be rendered by human beings rather than by machine.<sup>12</sup> Expansion of such services characterizes the society which is beginning to turn from conditions of plenty to conditions of surpluses. We are not, however, apt to see the day when production capacity exceeds the capacity to consume in every line of goods. New products will continue to appear, present products will continue to be improved, and marketing ingenuity will go on uncovering and developing new markets. But, as Professor Seibert warns, "the progress of industrial automation is destined to be delayed unless we can develop the mass mar-

<sup>10</sup> On this point, see: Galbraith, *op. cit.*, Ch. 21.

<sup>11</sup> See: M. Kestnbaum, "Redressing the Balance," *The Saturday Review*, January 17, 1959, p. 26.

<sup>12</sup> We doubt, for instance, that marketing professors will ever be fully supplanted by teaching machines. So far, not even the original teaching machine, the book, has kept their number from growing!

*kets to absorb this contemplated mass production."*<sup>12</sup> Undoubtedly, we will be hard-pressed to find ways to increase consumption of the outputs of the new automated factories, just as we have been in marketing agricultural surpluses in the past. Hence, businessmen are very likely to give increasing emphasis to finding better solutions to their firms' marketing problems. And they are likely to accord consumer behavior (i.e., buying and consuming behavior) ever-increasing recognition as the crucial determinant of economic progress and business success.

#### MARKETING AS A FIELD OF STUDY

Business, although not yet fully convinced of the value of scientific marketing, has devoted a great deal of time and money to the search for universal laws and principles. In an ideal economic society (i.e., in a Utopia), it would be possible to "engineer" consumption just as we have been largely able to engineer production—to the point of day-in, day-out predictability. This has not happened. Every one of our so-called marketing principles seems to have its exceptions, these in their turn often seeming to be new-found principles. And few, if any, of these so-called principles can be applied to all firms, at all times. One wry marketer has suggested that we do away with the factor that has been frustrating us all along. If we are naive enough to bite, he answers "the human factor." The inescapable fact is that the consumer is a human being, capricious by nature, and anything but a machine designed to consume the output of our factories. While he will permit us to make some generalizations about him, it is doubtful whether he will ever allow us any "universal truths." The alert marketer recognizes this.

#### APPROACHES TO STUDY OF MARKETING

The study of marketing can be approached through analysis of: (1) the marketing of individual products or classes of products, (2) the problems and operations of different marketing institutions, (3) the functions, or activities, performed in marketing, and (4) the decisions required in carrying on the marketing process. Each of these approaches is discussed below.

##### *Product Approach*

In applying the product (or commodity) approach to marketing study, description and analysis centers on problems encountered in marketing particular products—e.g., wheat, leather, textiles, or machine tools. The

<sup>12</sup> J. C. Seibert, "Marketing's Role in Scientific Management" in R. L. Clewett (Ed.), *Marketing's Role in Scientific Management* (Chicago: American Marketing Association, 1957), p. 2.

*marketing situation of each product chosen for study is examined from such standpoints as: sources and conditions of supply, producers' marketing organizations and policies, the different middlemen who take part in distributing the product, and characteristics and extent of the market for the product. The product approach, then, gives detailed analysis to the specific problems met in marketing particular products, and that is its great advantage. If, for example, you want to learn a great deal about marketing lumber, wheat, textiles, or some other product, the product approach is a logical way for you to study marketing. However, since the orientation of this approach is on products, it tends to be repetitious and time-consuming. Numerous products have to be traced through from producer to consumer in order to pick up marketing differences among products and, since there are many more similarities than differences in marketing most products, continual reference to marketing similarities makes this approach repetitious. Certain advanced courses in marketing, such as those in industrial marketing, make some use of the product approach, and colleges of forestry, agriculture, and fisheries sometimes offer specialized marketing courses which feature the product approach. Otherwise, however, the product approach sees relatively little use in marketing instruction.*

#### *Institutional Approach*

The institutional approach concentrates on description and analysis of the different institutions engaged in marketing (producers of all kinds, wholesalers, agents, retailers, and so on) and pays special attention to the problems and operations of each type of marketing institution. In applying the institutional approach, we might, for example, start with the field of retailing, consider the nature and significance of retailing in general, and then go on to the operations and problems of such institutions as department stores, supermarkets, mail-order houses, and shopping centers, and then perhaps, even more specifically, hardware stores, automobile dealers, and college and university book stores. For each of these institutions, we would seek to explain what marketing work it does and how it fits into the over-all marketing system, both with regard to the products it handles and the markets it serves. When we finished with the field of retailing, we would go on to examine wholesalers and institutions on other distribution levels. In other words, the institutional approach involves going through a great deal of detailed information about each of many types of institutions, and is usually tedious and repetitious. The institutional approach to marketing might be appropriate for a person interested primarily in supermarket retailing. However, the limited appeal of such specialized courses means that relatively few schools offer them,

although colleges of pharmacy, for example, do occasionally have a course in drug store retailing and trade associations sometimes arrange for "short courses" utilizing the institutional approach (e.g., both the American Association of Nurserymen and the Florists' Telegraph Delivery Association have for some years offered such courses for their members). Modified versions of the institutional approach are sometimes used in advanced marketing courses, namely those in retailing and wholesaling.

#### *Functional Approach*

The functional approach breaks down the field of marketing into the functions (i.e., the activities) which are necessarily performed in doing marketing work. These include, among others, such functions as buying, selling, storage, and transportation. In applying the functional approach, each function is analyzed relative to the importance of its performance in the marketing of different products, and according to the nature of its performance by different marketing institutions. Thus, for example, we might study the selling function in relation to the importance of its performance in the marketing of large appliances (i.e., stoves, refrigerators, etc.) and also as to how it is performed by each of the different institutions (manufacturer, wholesalers, and retailers) engaged in marketing large appliances. The functional approach developed at a later date than the product and institutional approaches and, since marketing involves a smaller number of functions than it does either products or institutions, the functional approach has two great merits: conservation of time, and avoidance of much repetition. By carefully investigating each of the functions performed in marketing and by analyzing the problems met in performing each, it is possible to gain an understanding of marketing. Most collegiate marketing courses make considerable use of the functional approach, though few, if any, rely on it exclusively.

#### *The Decision-Making Approach*

The approach we have used in this book is the decision-making, or management, approach, which combines certain features of the other three approaches and seeks to relate them from the decision-maker's viewpoint. Thus, we begin, in Chapter 2, with an analysis of two essential concepts—the product and the market (marketing is impossible without both products and markets), and here we will be using a modified version of the product approach. We follow, in Chapter 3, with an analysis of the marketing process and the functions performed during its various phases. (Notice that here we will be using the functional approach.) Next, in Chapters 4 and 5, we examine the channels through which products move to markets, and the institutions performing the marketing functions which result in the matching of products with markets, and in ownership trans-

fers. (Notice that this represents application of the institutional approach.) Thus, by the time we come to the end of Part One, we will have used all three of the older approaches—product, functional, and institutional—in laying the foundation for our further analysis of marketing through continued application of the decision-making approach.

Before we go on to explain the logic of the sequence with which we apply the decision-making approach in the rest of this book, we must further clarify what we mean by “uncontrollables” and “controllables.” We give the name “uncontrollables” to the continually interacting economic, sociological, psychological, and political forces which are the basic causes of market changes, but which cannot be appreciably influenced by the decisions and actions of any individual business firm. We use the term “controllables” to mean those marketing forces that individual firms put in motion as they make continual adjustments in prices, products, advertising, personal selling, and so on. Both the uncontrollables and the controllables are of great importance to the marketing decision-maker. The uncontrollables cause marketing opportunities to exist and set the limits within which decision-makers may apply the controllables in their efforts to capitalize on marketing opportunities.

So, in continuing our application of the decision-making approach, in Part Two we survey and analyze the uncontrollables, which collectively make up the environment within which marketing management must make decisions on the controllables. Then, since decisions are the means of relating controllables to uncontrollables, we analyze in Part Three the nature of the decision-making process in marketing, paying special attention to such fundamentals as the identification and diagnosis of marketing problems, the collection and interpretation of marketing information, and the measurement of markets and the forecasting of sales. Our discussion and analysis in Part Four focuses specifically on the controllables which are, after all, the “areas of marketing decision”—i.e., the factors which marketing management has the power to make decisions on, as it seeks to adjust the firm’s resources to the environment composed of uncontrollables. The areas of decision include such important controllables as: the marketing organization, the product, distribution policies and physical distribution, pricing, advertising, and personal selling.

Thus, after the basic introduction provided in Part One, we go on in Part Two to analyze the uncontrollables (i.e., the marketing environment), in Part Three to consider how marketing decisions are and should be made, and in Part Four to examine in detail the problems of making decisions on the marketing controllables.



**QUESTIONS AND PROBLEMS**

1. Explain and contrast the terms in each of the following pairs:
  - a. marketing and production
  - b. standard of living and manner of living
  - c. purchasing power and real income
  - d. "push" marketing strategy and "pull" marketing strategy
  - e. marketing controllables and marketing uncontrollables
2. Henry Ford, pioneer automobile manufacturer, once said "the consumer can choose any color he wants, so long as it's black." Contrast this statement with the modern philosophy of marketing and production.
3. "He who builds a better mousetrap will find the world beating a path to his door." How much truth is there in this age-old saying? Has it ever been true?
4. Economists often define production as "the creation of any good or service that people are willing to pay for." Compare this definition with the concept of production held by businessmen (and by most business students). According to this definition, can marketing be considered a form of production or not? Why?
5. It is a fact that every year total sales in this country exceed the total purchases of goods and services by consumers. What reasons might you advance to explain this?
6. Someone has said that "marketing both begins and ends with the consumer." Explain.
7. How does marketing add value to goods? Give a few examples.
8. Suppose that the government of one of the developing nations (e.g., Peru or Ecuador) employed you as a marketing consultant and gave you the assignment of "making recommendations conducive to raising the standard of living of the inhabitants." How might you go about carrying out this assignment?
9. Explain how consumption is affected by production, purchasing power, and marketing.
10. Why has the "self-contained, self-sufficient" community passed out of existence in this country?
11. Comment on the extent to which "democracy in the marketplace" has been a factor in developing mass markets for each of the following products: sports cars, television receivers, air travel, extension telephones.
12. What does leisure time have to do with marketing?

13. "If advertising, salesmen, and other forms of marketing effort had just not been so persistent, American consumers would have long ago been satisfied with their lots." Do you agree? Why or why not?
14. One recent visitor to the U.S.S.R. reported that "there are really no salesmen in Russia, and the closest thing to a Madison Avenue type is a *tolkach* (pusher), a charmer whose persuasive skills are applied to buying, not selling." Assuming that this report is true, how might you explain it?
15. What part, if any, has installment credit played in raising the American standard of living?
16. Employment figures show that the number of people employed in marketing has been increasing more rapidly than the number working in production. What are the main reasons for this?
17. Many marketers contend that "the solution to every marketing problem lies with the consumer." Is this contention valid? Why or why not?
18. "There is a natural limit on the capacity to consume and that is why we have agricultural surpluses in this country." Do you agree or disagree? Why?
19. "In a developing economy, it is patently more blessed to produce than to consume." Discuss.
20. What reasons are there for believing that marketing will be of increasing importance in the future?
21. Defending your answer in each instance, which approach to marketing study would you take in preparing a term paper on each of the following topics?
  - a. Expanding the market for room air-conditioners
  - b. Reducing the costs of marketing
  - c. Marketing Arizona-grown lettuce
  - d. The future of the grocery wholesaler
  - e. Marketing drug products through supermarkets

MARKETING

ESSENTIALS:

MARKETS

AND

PRODUCTS

# 2

Our main purpose in this chapter is to examine markets and products, the two essentials of marketing, in considerable detail. Earlier, you will recall, we defined marketing as “the business process by which goods and services are brought into contact with markets and through which transfers of ownership are effected.” Note that there are two essentials in marketing: (1) markets, and (2) products (i.e., goods and services). Without these two essentials, there can be no marketing. Note, too, that no transfer of ownership can take place unless there is both a market and a product. Markets and products are the twin foundations on which all marketing study is based. Thus, it is

appropriate that here, early in the book, we analyze and further define the market and product concepts. The intention is to provide the reader with a set of ideas about markets and products which should prove helpful later when we discuss marketing functions, marketing institutions, the forces affecting marketing, marketing decision-making, and marketing management.

### MARKETS AND MARKET SEGMENTATION

Depending on the way it is used, the term "market" has several different meanings. The American Marketing Association, through its definitions committee, suggests two: <sup>1</sup>

1. The aggregate of forces or conditions within which buyers and sellers make decisions that result in the transfer of goods and services.
2. The aggregate demand of the potential buyers of a commodity or service.

In an earlier report, this committee suggested two additional meanings: <sup>2</sup>

3. The place or area in which buyers and sellers function.
4. (As a verb) To perform business activities which direct the flow of goods and services from producer to consumer or user.

According to the first definition, markets are made up of people who buy and sell. The second definition highlights the notion that the market for a product also represents the demand for that product. The third carries the sense that a market is a place where goods change hands, the fourth defining market as an activity. In this chapter, we will, for the most part, use the term "market" in the sense of the second definition—i.e., as it consists of the aggregate demand of the potential buyers of a commodity or service. We must, however, amplify this definition a bit to fit the needs of our discussion. An aggregate demand is a composite of the individual demands of all the potential buyers of a product. But an aggregate demand, or total market, may also consist of the sum of the demands of different *segments* of the market, each market segment made up of a group of buyers, or buying units, who share qualities that render the segment distinct and make it of significance to marketing. Thus, in the second definition, a market is not only an aggregate demand for a product but consists of the sum of the demands of different market segments. According to the original definition, aggregate demand represents the total of the demands of all potential buyers. This definition is now modified so

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<sup>1</sup> Committee on Definitions, *Marketing Definitions* (Chicago: American Marketing Association, 1960), p. 15.

<sup>2</sup> "Report of the Definitions Committee of the American Marketing Association," *The Journal of Marketing*, Vol. XIII, No. 2 (October 1948), pp. 202ff.

that certain subtotals of demand, each representing the demand sum of a given market segment, are added together and then considered collectively as *the market*.

The following discussion is concerned with this market segmentation. Instead of examining the characteristics of potential buyers as individuals, we will examine them as members of groups. In other words, a group of individual potential buyers, all of whom possess common characteristics of distinctive significance to marketing, is a market segment. The sum of all such market segments is known as the market. Businessmen often say "market" when they really mean "market segment." In our discussion, "a market" means a market segment, "the market" meaning the total or whole market.

The existence of a group of individuals with common characteristics does not in itself constitute a market segment. Only when they have common characteristics as *consumers* can they be thought of as a market segment. Teenagers, for example, have long been considered a distinct part of the general population, but only recently have they taken on the characteristics of a distinct market segment. There was a time when the typical teenager received little or no spending allowance and had very little influence on the spending done on his behalf. As most teenagers can testify, a different set of circumstances exists today. The teenager now has much more spending money, not only from a more generous allowance but often supplemented by other sources of income, and he exerts a strong influence over the pattern of spending done by others on his behalf. To the extent that teenagers as consumers act differently than do other age groups, there is a teenage market. The distinctive marketing characteristics of such a market segment make it profitable for the marketer to adapt his product and marketing program to meet the needs of each segment. Thus, the marketer is well-advised to distinguish the different market segments which make up the total market for his product.

The broadest market division is that which separates the consumer market from the industrial market. This division, so broad that each part is too extensive to be properly considered as a market segment, separates potential buyers into two categories—ultimate consumers and industrial users. An ultimate consumer buys either for his own or for his family's personal consumption. An industrial user buys to further the production of other goods and services.

There are important differences between ultimate consumers and industrial users, their ways and means of purchasing differing considerably. Ultimate consumers buy in much smaller quantities and generally for consumption over much shorter time periods than do industrial buyers. More important is the fact that ultimate consumers are not usually as systematic in their buying as are industrial users. Some industrial users are business enterprises which exist to make profits, this encouraging them to adopt

systematic purchasing procedures. Other industrial users are non-profit institutions (e.g., governmental agencies, schools, and hospitals) whose operations are audited and reviewed by outside authorities, which condition also is conducive to the adoption of systematic purchasing procedures. Similarly, ultimate consumers spend only part of their time buying, whereas the industrial user, an organization of some size, employs professionals who devote all of their time and effort to purchasing. Furthermore, the ultimate consumer spreads all his buying skill over a wide range of goods and services, whereas the professional tends to specialize and, therefore, has more opportunity to perfect his purchasing skills. These are only a few of the many differences between ultimate consumers and industrial users. They should, however, illustrate the point that marketers must use significantly different approaches in marketing goods to each of the two broad classifications of markets.

#### *Ultimate Consumers*

Inasmuch as every individual may be classified as an ultimate consumer, there were approximately 150,000,000 consumers in the United States in 1950. In 1960, there were 180,000,000 people in the United States, or 30,000,000 more consumers, and it is estimated that the population will grow to 220,000,000 by 1975. Even the marketer who just manages to maintain his share of the market will be able to expect an increasing volume of business assuming, of course, that he can adapt his product and marketing techniques to the changing requirements of the consumer market.

For purposes of analyzing the consumer market, the household is a more significant analytical unit than the individual. There is a difference between a household and a family. A household includes all persons occupying a house, an apartment, or other group of rooms, or a room regarded as a dwelling unit. Therefore, any occupied dwelling unit is considered a household. In contrast, a family, according to the definition of the Census Bureau, is made up of a group of two or more persons related by blood, marriage, or adoption and residing together. Thus, all families are also households, but not all households are families. Although it is true that individuals do the consuming, most of their purchases are not made for their own personal consumption, but for the households of which they are members. Other purchases are jointly made by two or more persons who make up a household. Still other purchases are of goods which are consumed by all members of the household—as is the case with such household appliances as refrigerators, electric and gas ranges, and automatic dishwashers. More than one member of a household may have an income, but the usual situation is that all or part of these incomes are pooled for spending purposes. In addition, household members who do not have incomes still assist in spending the household income.

As explained above, then, in appraising the market for many consumer products, the total number of households is more significant than the total population. In 1956, there were 49,140,000 households in the United States, each spending an average of \$4,100, excluding expenditures for educational and philanthropic purposes, gifts, vacations, or capital outlays.<sup>3</sup>

**BASES FOR DIVIDING MARKETS INTO SEGMENTS.** Most major market segments result from groupings based on income, age, degree of urbanization, geographic location, or education. These groupings do not represent all the possible ways in which markets can be divided for analysis. Other such schemes are introduced and analyzed in later chapters. Social class segmentation, for example, is treated in Chapter 9, "Sociological Factors Affecting Consumer Demand." In addition, some market segments may be further broken down into sub-segments by cross-classifying the grouping of market segments in terms of a different grouping system. The following table, for instance, shows how an analyst might break down income market segments into sub-segments according to the ages of income recipients, each box representing such a sub-segment. The box marked "X," then, would represent those persons with incomes of \$7,500 and over who were in the 18-24 age group.

<i>Age Group</i>	<i>Income Group</i>			
	<i>Under \$3,000</i>	<i>\$3,000- \$4,999</i>	<i>\$5,000- \$7,499</i>	<i>\$7,500 &amp; Over</i>
18-24				X
25-34				
35-44				
45-54				
55 & Over				

**INCOME MARKET SEGMENTS.** Because income is the main source of consumer purchasing power, market segmentation based on income is entirely logical. An individual's income, in most cases, limits not only how much he can buy but what specific products and services he buys. The

<sup>3</sup> *Life* magazine conducted an exhaustive survey of consumer spending in 1956, collecting detailed expenditures on all goods and services from a nationwide probability sample of 10,243 households. The results represent a unique contribution in terms of marketing data. The only similar study made previously was a Department of Labor Statistics study of urban markets only, and shortage of funds prevented processing and publishing of the findings while the information was up-to-date. Because of the wealth of new data unearthed by the *Life* study, it has been used as an important source of data for this chapter.

person with a low income, for example, is often so hard-pressed to pay for such necessities as food, clothing, and shelter that he cannot afford to buy tickets for the opera and contents himself instead with attendance at the neighborhood theater. Similarly, persons with relatively low incomes who buy new homes are much more likely, because of financial pressures, to plant their own trees and shrubs than they are to employ the services of landscape gardeners. Whereas low incomes result in highly restricted consumption, the only limit to consumption at the upper end of the scale is the availability of goods and services. For incomes between the two extremes, patterns of buying and consumption vary considerably from one income step to the next.

In delineating income market segments, we must arbitrarily set dividing lines between different income levels. If we set a \$5,000-\$6,999 income market segment, a person with a \$4,999 income will fall into the next lower market segment, even though he may share certain consumer characteristics with the person who has a \$5,000 income. But in spite of this limitation, there is considerable advantage in classifying consumers according to their income, for in no other way can we derive a usable measure of buying power, which is, as we mentioned earlier, ultimately based on income. Table 2.1 shows the distribution of income among United States households in 1956. More households were earning between \$5,000 and \$6,999 than any other range of income, and more than two-thirds, 68 per cent, earned more than \$3,000.

**Table 2.1**  
Pre-Tax Annual Income per American Household in 1956

<i>Annual Income Before Taxes</i>	<i>% of Total Households</i>
Under \$2,000	18%
2,000-2,999	14
3,000-3,999	15
4,000-4,999	19
5,000-6,999	20
7,000-9,999	9
10,000 and over	5
	<hr/> 100%

Source: *Life Study of Consumer Expenditures*, Vol. 1, 1957.

Table 2.2, which divides America's households into three income segments, each with approximately the same number of households, reveals that the top segment (incomes of \$5,000 and over) accounts for nearly half of all spending. The middle segment, covering incomes of \$3,000 to \$5,000, accounted for 34 per cent of all spending, the lower segment (incomes under \$3,000) for a little less than one-fifth. Upper income households account for disproportionately large shares of total spending relative



to their numbers, and this is especially apparent with respect to the following categories of goods and services: home furnishings, equipment, and appliances; alcoholic beverages; automotive; recreation; and clothing. By contrast, such disproportionality, while still present, is not nearly so marked in the food and tobacco categories.<sup>4</sup>

**Table 2.2**  
Percentage Division of Total Spending  
Among U.S. Households of Various Incomes, 1956

	<i>Household Income Before Taxes</i>		
	<i>Under \$3,000</i>	<i>\$3,000 to \$5,000</i>	<i>\$5,000 or more</i>
Per Cent of U.S. Households	32%	34%	34%
Total Expenditures	19	34	47
Food, Beverages, Tobacco	22	35	43
Food	22	35	43
Alcoholic Beverages	20	30	50
Tobacco	22	36	42
Clothing, Accessories	17	35	48
Home Operation, Improvement	18	35	47
Home Furnishings, Equipment, Appliances	17	32	51
Medical, Personal Care	21	33	46
Automotive	16	34	50
Recreation	17	34	49
Other *	16	33	51

\* Includes life insurance premiums and non medical professional services.

Source: Derived from data contained in *Life Study of Consumer Expenditures*, Vol. 1, 1957. Also see R. H. Osheimer, "Who Buys What? Life's Study of Consumer Expenditures," *The Journal of Marketing* (January 1958), p. 266.

Although households have different amounts of money available for spending, there is remarkable conformity in spending patterns among households in different income groups. By spending pattern, we mean the *percentage* division of a household's total expenditures into spending for each major category of goods and services. The *Life Study of Consumer Expenditures* showed that, with the exception of spending on food, households in different income groups spend about the same percentages for each category of goods and services. Households with under \$4,000 in annual income spend around one-third of the total for food, while those with over \$7,000 in income spend only one-fourth of the total for food. But in buying goods and services in other major categories, all households, regardless of their income class, allocate nearly the same proportions of their total

<sup>4</sup> R. H. Osheimer, "Who Buys What? Life's Study of Consumer Expenditures," *The Journal of Marketing* (January 1958), p. 266.

budgets.<sup>5</sup> Table 2.3 shows how the average U.S. household, which had total expenditures of \$4,110 in 1956, divided its expenditures among different categories of goods and services. However, similarity in spending patterns as measured by the shares of the budget allotted to major categories does not mean that all households are equally good market prospects. Households in the \$3,000-\$3,999 and \$7,000-\$9,999 annual income brackets, for instance, both devoted 5 per cent of their total expenditures, i.e., the identical percentage allocation made by the average U.S. household, to purchases of recreation and recreation equipment. But the household in the \$3,000-\$3,999 income group spent only \$192 on these items, while the

**Table 2.3**  
How the Average U.S. Household Divided Its Dollars  
For Consumer Goods and Services in 1956

<i>Expenditure Category</i>	<i>\$ Spent</i>	<i>Expenditure as a % of Total Spending</i>
Food	\$1,036	25%
Home Operation & Improvement	763	19
Automotive	591	14
Clothing	494	12
Home Furnishing Equipment	346	9
Medical, Personal Care	222	5
Recreation	215	5
Tobacco	121	3
Alcoholic Beverages	46	1
Miscellaneous	276	7

Source: *Life Study of Consumer Expenditures*, Vol. 1, 1957

household in the \$7,000-\$9,999 income group was spending \$322. This indicates, then, that higher-income households represent much better market prospects for recreation and recreation equipment than do households with lower incomes.

Current data on the incomes of different market segments is very helpful to the marketer who wishes to estimate the number of potential customers who can afford to buy his products. When these data are related to spending patterns, such as those uncovered by the *Life* study, the marketer is able to differentiate more clearly among income market segments. If he is planning marketing strategy for a line of golfing equipment, for instance, he very definitely would promote higher-priced clubs more intensively to the \$7,000-\$9,999 income group than to the \$3,000-\$3,999 income group. Furthermore, as we will see in a later chapter, there is a tendency for American households to move into progressively higher in-

<sup>5</sup> *Ibid.*

come groups which, in turn, makes these groups increasingly important as targets for marketing effort. Thus, in planning and implementing marketing strategy, it helps to be aware of income and spending patterns.

**AGE MARKET SEGMENTS.** When market segments are set up in terms of chronological age, the total population is separated into such groups as children, teenagers, adults, and the aged.

The children's and infants' market segment has long been recognized as a distinct grouping of consumers. Many products are designed specifically for this market segment, including not only clothing and toys but such items as scaled-down furniture and specially-prepared foods and beverages. The marketing problems presented by this segment are unique because the child, who actually uses or consumes the product, is seldom the one who does the buying. Marketers, however, realize that children can influence buying decisions, this influence increasing with the age of the child, and advertisers have demonstrated that appeals directed even to very young children cause them to bring strong buying pressure to bear on their parents. For instance, witness the television programs for children on which the commercials are directed specifically to children. The continued use of such programs and commercials by advertisers is some evidence of their effectiveness.

Recognition that teenagers constitute a separate market segment has come only fairly recently. For many years, marketers classified teenagers either as children or as adults, using some age, such as 15 or 16, as the dividing line. By the early 1950's, however, it was a rare marketer that did not realize that teenagers were a distinct market segment. Being neither children nor adults, teenagers are a distinct social as well as age grouping. They have their own social rules and, what is most significant to marketers, their own patterns of buying behavior and product and brand preferences. Furthermore, teenage social groups exert strong influences on individual buying decisions. Addressing themselves to the special qualities of this segment, marketers have, for example, designed typewriters especially for high school and college use and compounded beauty preparations specifically for adolescent complexions. Marketers have also advertised directly to teenagers using copy and commercials phrased in the teenagers' own language. Among the companies which have approached the teenage market segment in this way are Coca-Cola, Remington Arms, Eastman Kodak, and John H. Breck (Shampoos).<sup>6</sup>

Marketers still do not fully recognize the existence of a "senior citizen" or "oldster" market segment. As the average life span has increased, the

<sup>6</sup> For an interesting description and analysis of the teenage market segment, see: E. Gilbert, *Advertising and Marketing to Young People* (Pleasantville, N.Y.: Printers' Ink Books, 1957).

size of this segment has expanded greatly. There has also been significant growth in the importance of this market segment relative to others. Population statistics show that persons in the over-65 age group in 1940 were only 6.9 per cent of the total; in 1950 they were 8.2 per cent; and in 1960 nearly 8.7 per cent. By 1950 about 21.8 million people, or 9.5 per cent of the population, will be in the over-65 group.<sup>7</sup> With the almost complete disappearance of large multi-generation families and with the greater degrees of financial independence made possible by social security and company retirement plans, more and more older people are maintaining their own households. Although there is little doubt that these households make up a separate market segment, many aging people do not want to be identified as "old and apart." Housing developers have discovered that many aging people prefer to live in "mixed-age communities" rather than in planned "retirement communities." Clothing designers also are learning that there is only a small demand for separately identifiable old people's styles. But marketing men should recognize that aging people, although they will reject anything that is clearly "old and apart," do, in the very nature of their needs, constitute a distinct market segment. In housing, for example, not only are their space requirements minimal, but the prices they can pay are often limited by the size of their retirement incomes. Recognizing this, many alert home builders have begun to include several smaller retirement homes, although not labeled as such, in housing developments built primarily for younger families.

Market segmentation by stage in the life cycle, a concept developed by the Survey Research Center of the University of Michigan, classifies households according to the age of the household head, marital status, and the presence or absence of children. Households in the first stage are those in which there are no children and the household head is under the age of 40, married or unmarried. The second stage households include young children with or without older children. The third stage households include older children but no young children, and the fourth stage households are ones with heads aged 40 or older who are married but who have no children under the age of 20 residing in the household. In households of the fifth and final stage, there are no children and the household head is single and aged 40 years or older.

Consumers have different needs at varying stages in the life cycle. Newly married couples, for example, are especially large buyers of furniture and household goods. Families with young children are very good customers for labor-saving appliances. Families with teenage daughters spend sizable sums on girls' and women's clothing. Table 2.4 shows how expenditures on selected items vary with the stage in the life cycle.

<sup>7</sup> "As Population Keeps Climbing," *U.S. News & World Report*, Jan. 2, 1959, p. 55.

Table 2.4

Average Annual Expenditures per Household  
on Selected Items by Stage in the Life Cycle

	All House- holds	No Children Single or Married Head under 40	Children		No Children	
			Under 10	10-19 only	Married Head 40 or over	Single Head 40 or over
Total Expenditures	\$4,110	\$4,332	\$4,607	\$4,881	\$3,639	\$2,350
Prepared mixes	5	3	6	5	4	2
Major Appliances	84	87	107	89	68	33
Household waxes, Polishes, Cleaners	5	4	7	5	5	2
Women's and Girls' Clothing	210	236	196	298	195	158

Source: Data compiled from *Life Study of Consumer Expenditures*, Vol. 1, 1957.

MARKET SEGMENTS ACCORDING TO DEGREE OF URBANIZATION. Table 2.5 shows that suburban households represent a proportionally richer market segment than do either urban or rural households. In this instance, rural households include both farm households and households in towns and villages of less than 2,500 population. Suburban households are located in metropolitan areas outside the corporate limits of large cities. Although there is only a small difference in total per household spending among households in these three groups, there are considerable differences in spending for individual products. For instance, suburbanites were responsible for only 31 per cent of total consumer expenditures in 1956, but accounted for 47 per cent of total spending on removable floor coverings and 45 per cent of the total spent on sporting goods. At the same time, however, farmers made only 20 per cent of all consumer expenditures but accounted for a disproportionately large share (30 per cent) of total spend-

Table 2.5

Number of U.S. Households and Expenditures  
per Household in 1956 by Location of Residence

	Number of Households	(Percentage)	1956 Expenditures	(Percentage)
U.S. Total	49,140,000	100%	\$200 billion	100%
Farm	12,410,000	25	40 billion	20
Suburban	13,180,000	27	63 billion	31
Urban	23,550,000	48	97 billion	49

Source: Assembled and computed from data contained in *Life Study of Consumer Expenditures*, Vol. 1, 1957.

ing for gasoline and oil.<sup>8</sup> The rich suburban market for removable floor coverings and sporting goods traces directly to the characteristically higher incomes enjoyed by suburban households. Farmers, in contrast, spend more for gasoline and oil, not because of the size of their incomes, but because of their relative remoteness and the increasing use being made of mechanized farm equipment.

**GEOGRAPHICAL MARKET SEGMENTS.** Within different parts of the United States, there are sufficient variations in consumption patterns to justify geographical market segmentation. These variations are the result of differing cultural heritages, topography, and climates, and have significant implications for the marketers of some products. Furniture manufacturers, for example, find that consumer style preferences vary considerably among different geographic sections. The southern consumer shows a much stronger preference for traditionally styled furniture than does the Midwesterner. Similarly, many a far western consumer has a noticeably strong preference for furniture styles which show certain oriental influences. Other examples of distinctive regional preference are to be found in food, clothing, floor coverings, paint, and housing. Differences in climate also make for geographic market segmentation. For instance, areas with very hot summers are much better markets for home and automobile air conditioners. Similarly, those areas which have considerable winter snow are the most fertile sales areas for winter sports equipment.

Even more important to the marketer than regional variations in culture and climate are the regional variations in income. Table 2.6 shows the changes in total per capita income, by states and regions for selected years, 1929 through 1957. Despite the substantial gains made by the Southeast and Southwest in per capita income during the twenty year period, the Mideast and Great Lakes regions are still far richer markets. To the soap manufacturer, these income differentials are of small importance, but to the automatic dishwasher manufacturer, the higher income regions are much riper selling areas. In analyzing the per capita incomes of different regions, we must remember that inter-regional variations in income are not usually as great as the difference between urban and rural incomes within a single region. Hence, because Birmingham, Alabama and Cincinnati, Ohio are both large cities, the income of a person who lives in Birmingham is closer to that of the resident of Cincinnati than it is of an Alabama farmer.<sup>9</sup>

<sup>8</sup> Ostheimer, *op. cit.*, pp. 268-9.

<sup>9</sup> For 1959, per capita income was estimated at \$1,751 for Birmingham and \$2,321 for Cincinnati, compared to the estimate of \$988 per capita income in predominantly rural Fayette County, Alabama. "Survey of Buying Power," *Sales Management*, July 10, 1960.

**Table 2.6**  
**Changes in Total Per Capita Personal Income,**  
**by State and Regions, Selected Years, 1929-57**

<i>State and Region</i>	<i>Total Personal Income</i>				<i>Percent increase</i>		
	<i>Percent of</i>				<i>1929</i>	<i>1950</i>	<i>1956</i>
	<i>1929</i>	<i>1940</i>	<i>1950</i>	<i>1957</i>	<i>to</i>	<i>to</i>	<i>to</i>
					<i>1957</i>	<i>1957</i>	<i>1957</i>
Continental United States	100.00	100.00	100.00	100.00	303	53	5
New England	8.32	8.15	6.73	6.57	218	49	5
Maine	.56	.57	.48	.45	227	44	3
New Hampshire	.38	.36	.31	.31	231	52	6
Vermont	.26	.23	.20	.18	178	40	4
Massachusetts	4.51	4.32	3.45	3.29	194	46	6
Rhode Island	.69	.68	.57	.50	188	33	1
Connecticut	1.92	1.99	1.72	1.84	287	65	6
Mideast	32.06	30.50	26.36	25.46	220	48	5
New York	16.47	14.92	12.43	11.86	190	46	5
New Jersey	4.33	4.37	3.86	4.07	279	62	6
Pennsylvania	8.79	8.17	7.30	6.76	210	42	5
Delaware	.28	.34	.31	.35	400	74	1
Maryland	1.47	1.67	1.67	1.81	395	66	5
District of Columbia	.72	1.03	.79	.61	240	18	3
Great Lakes	23.61	22.69	22.51	22.46	283	53	4
Michigan	4.44	4.60	4.79	4.84	339	55	2
Ohio	6.04	5.86	5.72	6.01	301	61	5
Indiana	2.30	2.42	2.66	2.64	362	52	4
Illinois	8.50	7.59	7.10	6.82	224	48	4
Wisconsin	2.33	2.22	2.24	2.15	271	47	5
Plains	8.87	8.30	8.80	8.08	268	41	7
Minnesota	1.80	1.87	1.86	1.78	299	47	7
Iowa	1.66	1.62	1.68	1.46	256	33	12
Missouri	2.66	2.52	2.53	2.39	263	45	3
North Dakota	.30	.29	.35	.27	265	18	2
South Dakota	.34	.29	.35	.31	273	36	19
Nebraska	.95	.74	.86	.76	226	35	15
Kansas	1.16	.97	1.17	1.11	282	44	6
Southeast	11.67	13.23	15.17	15.38	431	55	5
Virginia	1.23	1.62	1.78	1.82	498	57	4
West Virginia	.93	.99	.96	.89	287	39	7
Kentucky	1.19	1.16	1.26	1.21	309	47	4
Tennessee	1.15	1.27	1.46	1.39	388	46	4
North Carolina	1.22	1.49	1.82	1.72	466	44	1
South Carolina	.55	.74	.83	.81	495	50	4
Georgia	1.18	1.35	1.56	1.57	433	54	3
Florida	.88	1.25	1.61	2.17	899	107	10
Alabama	1.00	1.02	1.18	1.21	387	57	7
Mississippi	.67	.60	.71	.61	167	32	1
Louisiana	1.01	1.10	1.30	1.39	455	64	10
Arkansas	.66	.64	.68	.59	261	32	3
Southwest	4.97	5.21	6.50	6.79	451	60	7
Oklahoma	1.26	1.10	1.11	1.07	242	47	4
Texas	3.21	3.54	4.61	4.73	495	58	7
New Mexico	.20	.25	.35	.41	718	75	12

Table 2.6 (cont.)

State and Region	Total Personal Income				Percent increase		
	Percent of continental United States				1929	1950	1956
	1929	1940	1950	1957	to 1957	to 1957	to 1957
Arizona	.30	.32	.43	.58	683	103	9
Rocky Mountain	1.88	2.03	2.23	2.24	379	54	7
Montana	.36	.40	.42	.37	305	32	3
Idaho	.26	.31	.34	.30	364	38	3
Wyoming	.18	.19	.21	.19	326	36	6
Colorado	.75	.79	.86	.96	420	73	10
Utah	.33	.34	.40	.42	408	62	8
Far West	8.62	9.89	11.70	13.02	508	70	6
Washington	1.36	1.47	1.77	1.68	397	45	6
Oregon	.75	.86	1.09	.98	423	38	1
Nevada	.09	.13	.14	.19	719	106	7
California	6.42	7.43	8.70	10.17	539	79	6

Source: *Survey of Current Business*, August 1958, p. 10.

EDUCATIONAL ATTAINMENT AND MARKET SEGMENTATION. Variations in education have a pronounced effect on the buying habits and patterns of individual consumers. But there is also a close relationship between education and income, so that it is difficult to say whether a college graduate buys an item because of his education or because of his high income. Sometimes, of course, a person has much education but a low income, causing him to scrimp on other things to buy such items as books and high-class magazines. For the most part, though, it is probably true that educational and income factors jointly influence the consumer to have a better-than-average library and to subscribe to magazines such as *The Atlantic Monthly*. Yet, many persons who have achieved high income status with less education may buy the same books and subscribe to the same publications in order to conform. However, if the income variable could be held constant, it undoubtedly would be very clear that variations in education result in unique market segments for many kinds of products and services. We might, then, know for sure whether educational or income factors or both are responsible for such phenomena as the following: the majority of encyclopedia buyers have had no formal education beyond high school; most buyers of classical records have had some instruction in music; Scotch whisky and other hard liquors are more preferred by persons with college educations than by persons with less, while beer and ale are the most popular drinks of persons without college educations. The *Life Study* showed that households headed by persons with "some college or beyond" (one-fifth of all households) accounted for 26 per cent of total spending, but they made 31 per cent of the expenditures for frozen foods,



30 per cent of the housing expenditures, and 32 per cent of the photographic equipment expenditures. By contrast, households headed by persons who did not finish grade school (also about one-fifth of all households) did only 13 per cent of the total spending, and made only 11 per cent of the frozen foods expenditures, 11 per cent of housing expenditures, and 8 per cent of photographic equipment expenditures. This indicates that households headed by persons with college educations not only have more money but spend proportionally more on items where buying decisions are strongly influenced by the sophisticated and discriminating tastes that college educated individuals are likely to possess. Expenditures on frozen food, housing, and photographic equipment are directly related to the consumer's education, but there are some products for which the consumer's demand is inversely related to the amount of his education. Spending on cooking, baking, and salad ingredients, for example, tends to be higher in the lower educational levels. Households headed by persons who did not finish grade school make 32 per cent of the expenditures in this category, and households headed by persons with "some college or beyond" make only 19 per cent.<sup>10</sup> Probably differences in dietary preferences and eating habits, both of which are doubtless influenced by education, explain this inverse relationship.

#### *Industrial Users*

Industrial users, as mentioned earlier, make purchases to further the production of other goods and services. The goods and services so produced may be destined either for the ultimate consumer market or to other parts of the industrial market, which includes both private enterprises and governmental agencies. The category is, in fact, so broad that any organization, private or public, which makes purchases in order to facilitate the performance of manufacturing, marketing, or institutional activities may be considered an industrial user. Thus, the different types of industrial users engaged in producing and marketing goods range all the way from the individual farmer to the large manufacturer. Those engaged in marketing services are as diverse as the independent insurance agent and free-lance writer at one extreme to the large hospitals, theaters, and hotels at the other. Also included are transportation and public utility companies, schools, military installations, prisons, and all other types of governmental units. In short, any organization is classed as an industrial user if it purchases some goods and services *not for resale in the same form* but in order to use them in connection with its operation. Therefore, to the extent that they buy products for resale in the same form, retailers, wholesalers,

<sup>10</sup> All percentage figures in this paragraph are taken from the *Life Study of Consumer Expenditures*, Vol. 1, 1957.

and other middlemen are not considered industrial users. But when retailers, wholesalers and other middlemen buy products (e.g., display equipment and cash registers) and services (e.g., accounting service and the advice of business consultants) for use in furthering their operations, they may be considered industrial users.

The industrial market is a large one<sup>11</sup> and, like the consumer market, is made up of many market segments. Therefore, consideration of market segmentation is equally as important for industrial as for consumer goods. Separating industrial users into groups facilitates analysis of the industrial market. There are many bases which can be used in segmenting the industrial market, the four most important and most used bases being kind of business or activity, geographical location of the user, usual purchasing procedure, and size of user.

**KIND OF BUSINESS OR ACTIVITY.** One of the most useful ways of segmenting the industrial market, and the one used by practically all government agencies, is known as the S.I.C., or Standard Industrial Classification System. Under this system, all places of business are classified into one of ten divisions covering the entire field of economic activities: agriculture, forestry, and fisheries; mining; construction; manufacturing; transportation, communication, electric, gas, and sanitary services; wholesale and retail trade; finance, insurance, and real estate; services; government; and "all others" or "nonclassifiable establishments." Each of these ten divisions is broken down into several "major groups" representing specific kinds of business. The manufacturing division, for example, is broken down into such major groups as textile mill products, printing and publishing, and chemicals and allied products, each major group having assigned to it a two digit S.I.C. number. Manufacturers of furniture and fixtures would be classified under S.I.C. #25. Still further classification is effected through three and four digit numbers with manufacturers of household furniture coming under S.I.C. #251, and manufacturers of metal household furniture coming under S.I.C. #2514. Thus, by using the S.I.C. system, the industrial market can be divided into relatively small, medium, or large market segments. A knowledge of this system is essential to the market analyst who uses reports published by governmental agencies.<sup>12</sup>

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**GEOGRAPHICAL MARKET SEGMENTS IN THE INDUSTRIAL MARKET.** Segmentation of the industrial market, like the consumer market, may also be done on a geographical basis. Such factors as variations in topography, climate, and historical tradition cause considerable variation in the way industrial marketing is conducted in different areas. The topography of an area, for example, will obviously affect the types and costs of transportation available for shipping industrial goods. Thus, a firm marketing a heavy and relatively cheap industrial product, such as cement or coal, often can cultivate a distant industrial user only if transportation rates are low enough to permit successful competition with similar suppliers nearer the particular user. Similarly, variations in climate affect the needs of industrial users for building materials and heating and cooling equipment, just as the same variations cause differences in the demand for certain consumer goods. Differing regional traditions may, for example, show up in a greater demand for labor saving devices in areas where wage rates are relatively high. Regional differences, based partly on tradition and partly on management philosophy, also affect whether or not manufacturers provide in-plant feeding, recreation, and health-care facilities for their employees, these facilities being much more common in the Northeast and Midwest than elsewhere throughout the country.

In addition, different geographical segments of the industrial market exist because some kinds of business and service organizations seem to settle in certain areas. Some types of industrial users form geographical clusters because their locations have been dictated by the source of raw materials; for example, the lumber industry in the Pacific Northwest and the copper mining industry in Arizona, Montana, and Utah. Others located at points enjoying relatively easy access both to raw materials and to large markets; for example, the major concentrations of the steel and automobile industries in the Great Lakes region. The pressing need for reservoirs of highly-talented scientific personnel is the major reason why most companies in the electronic component industry located in and around Boston, San Francisco, and on Long Island. A combination of historical accident, the momentum of an early start, and tradition appears to account for the presence of numerous insurance company home offices in Hartford; much of the shoe industry in New England, New York, Pennsylvania, and Missouri; and the bulk of the entertainment industry in Southern California and New York City. Because of this tendency for some kinds of industrial users to locate in a small number of areas, marketers selling to such users have to adjust their distribution policies accordingly. Even though most companies in an industry may be located in a few areas, practically always there are a few situated elsewhere. This leads many marketers of industrial products, such as those selling shoe findings, to maintain their own full-time salesmen in areas where most

customers are concentrated and either to call less frequently on outlying accounts or reach them through middlemen. Similarly, such marketers often operate their own warehouses in areas of customer concentration and rely on shipments from the factory for supplying customers situated elsewhere. Marketers generally find that it costs more to sell to outlying customers than to those concentrated geographically. Under these conditions, then, different marketing approaches and programs are usually needed.

However, not all of the industrial market is characterized by this geographical clustering. Some types of users, such as schools and small retailers, are simply located wherever there are people. Other types of users, such as military installations, some kinds of wholesalers, and agencies of state and local governments, while not to be found everywhere are still rather widely dispersed. Nevertheless, in formulating distribution policies and deciding upon selling procedures, the concentration or lack of concentration of the industrial users of the product is a highly important consideration. In either case, the industrial marketer can benefit by separating his potential users into market segments on the basis of geography.

**INDUSTRIAL MARKET SEGMENTATION ON THE BASIS OF USUAL PURCHASING PROCEDURES.** Industrial users are generally more careful buyers than are ultimate consumers. But even among industrial users, there is much variation in the amount of consideration given in buying industrial goods. The purchase of a major item, such as a blast furnace or cement kiln, requires extensive market and other technical investigations plus the approval of several high executives in the industrial user's organization. In the same firm, however, the purchase of supplies such as office stationery or pencils is a routine procedure of concern only to the purchasing agent. The industrial marketer must apply different selling tactics and strategies to each of these buying situations.

Finally, purchasing procedures may vary even for the same industrial product. An industrial user who is buying an item as original equipment will usually follow a more complex purchasing procedure than if he were buying the same item as replacement equipment. Because of relative unfamiliarity and lack of experience with the product, the industrial user buying an item as original equipment demands fuller and more technical information about it, often conducts an exhaustive study of potential suppliers and their products, and more of the user firm's executives participate in the buying decision. When the item is being bought as replacement equipment, experience and familiarity with the product make it possible for the buying decision to be made in a more routine fashion. Recognizing this, some industrial marketers have further separated their markets into original equipment and replacement equipment segments.

**INDUSTRIAL MARKET SEGMENTATION BY SIZE OF USER.** In the industrial market there is a much wider range in the size of customers than there is in the consumer market. Industrial users may vary in size from those with very few employees to those with many thousands of employees. They vary all the way from the small machine shop in an old garage to industrial giants such as Lockheed Aircraft Corporation and Radio Corporation of America. Consequently, the size of a purchase of industrial goods may vary greatly. Because it normally is more economical to sell in large lots than small, the industrial marketer often sets lower prices for purchasers placing large orders than he does for those buying in small quantities. More important, this characteristic is often the main reason why marketers frequently use different methods for reaching industrial users who vary greatly in size. Thus, there is ample reason for market segmentation based on the size of industrial users.

#### **THE PRODUCT: MARKETING CHARACTERISTICS OF GOODS AND SERVICES**

Any adequate definition of the product must include services as well as tangible goods. A laundry, which sells the service of cleaning clothes, is just as surely engaged in marketing as the retail store which originally sold them. Clearly, then, enterprises that have something to sell, tangible goods or not, are selling products. In fact, any firm that "has something to sell" sells services as part of that something, even though it may be selling tangible goods rather than service *per se*. In commenting on this matter, Wroe Alderson, a widely-known business consultant and marketing theorist, suggests that "a product should be considered as a bundle of utilities consisting of various product features and accompanying services."<sup>18</sup> A product, therefore, is both "what a seller has to sell" and "what a customer has to buy." When a man buys a suit from a clothing store, for example, he buys not only the garment itself but the clerk's assistance and advice, the store's alteration service, the prestige of the store's and maker's labels, perhaps "charge and delivery" services, and the privilege of returning the item for refund or allowance should it fail to yield the expected satisfaction. Looked at in this light, the clothing store is selling not only men's suits and services related thereto but bundles of utilities which provide customers with both physical and psychological satisfaction as they consume their purchases.

It is necessary at this point to insert a word of caution with respect to semantics. One often finds in discussions of marketing topics that the word "good" is used as a synonym for "product." This is in line with both long-standing business usage and well-established academic custom. The businessman and the marketing professor simply say "good" when they

<sup>18</sup> W. Alderson, *Marketing Behavior and Executive Action* (Homewood, Ill.: Richard D. Irwin, 1957), p. 274.

mean "product," as the latter term was defined earlier. Note carefully, though, that when "good" is used in this broad sense, it may apply either to a product consisting of some tangible good and associated services or to one which consists of services alone. In the following discussion, as indeed throughout this entire book, "good" and "product" are used interchangeably.

The two major categories of goods are consumers' goods and industrial goods. Depending upon the purpose for which it is primarily destined to be used, any good may be classed as a consumer good or as an industrial good. Consumers' goods are destined for final consumption by ultimate consumers and households. Television sets, cigars and cigarettes, and potted geraniums are all examples of consumers' goods. Industrial goods are destined for use in the commercial production of other goods or for use in connection with carrying on some business or institutional activity. Crude petroleum, machine tools, and electronic computers are all industrial goods. Actually, not many goods can be classified *exclusively* as industrial goods. Typing paper, for example, is used for business purposes, but it may also be used for love letters. Typing paper, then, is both a consumer good and an industrial good. The same article may, under one set of circumstances, be an industrial good, and under other conditions a consumer good. Why is this apparently artificial distinction important? Consumers' goods and industrial goods are bought for different purposes. Of even greater significance for marketing is the fact that their purchasers have different approaches to the making of buying decisions. Consequently, marketing situations and problems also vary, depending upon whether the product is being marketed as a consumers' good or an industrial good.

### Consumers' Goods

Everyone knows that the variety of consumers' goods is almost endless. Literally, these goods range from A to Z—aspirin to zippers, and include such diverse items as chewing gum, pleasure yachts, grass seed, and complete frozen TV dinners. There are so many different consumers' goods that it is clearly impractical to analyze each consumer item individually. Two classification systems for consumers' goods, devised to facilitate marketing analysis, are presented in the discussion which follows.

### "Traditional" Classification of Consumers' Goods

Sometime before 1923, Professor Melvin T. Copeland of the Harvard Business School, a pioneer marketing teacher, set up what is now known as the traditional system for classifying consumers' goods.<sup>14</sup> Copeland based his classification system on differences in consumer buying attitudes

<sup>14</sup> See: M. T. Copeland, "Relation of Consumers' Buying Habits to Marketing Methods," *Harvard Business Review*, April 1923, pp. 282-9.

and behavior. Under this system, three classes of consumers' goods are identified as convenience goods, shopping goods, and specialty goods.<sup>15</sup>

**CONVENIENCE GOODS.** Items that the consumer buys frequently, immediately, and with minimum shopping effort are classed as convenience goods. Examples of convenience goods include cigarettes, candy and chewing gum, magazines and newspapers, gasoline, drugs, and most grocery products. Note that these are all non-durables, i.e., they are consumed or "used up" rather rapidly; hence, consumers buy them frequently and normally neither postpone their purchases nor make them much in advance of the time of consumption. Note, too, that, in buying convenience goods, habit dominates the consumer's behavior. Through force of habit, it is relatively easy for the consumer to arrive at buying decisions. In buying cigarettes and gasoline, for example, the consumer knows which brands he prefers, and he knows the retail outlets where he generally buys them. Little or no conscious deliberation is required in making such buying decisions. The typical consumer attempts to minimize the amount of time and effort devoted to buying convenience goods.

In making buying decisions for most convenience goods, the consumer rarely bothers to compare competing items on the bases of price and quality. The possible gains from making price and quality comparisons are not large enough to justify the costs involved in terms of time and effort. "It isn't worth shopping around for" expresses this buying attitude of the typical consumer in buying most convenience goods. However, if the price or quality of a convenience good, such as a certain brand of bread, gets too far out of line with competing brands, many consumers revise their buying decisions. Note, though, that the possible gains to the consumer in such situations outweigh the costs in time and effort. For this reason, marketers of convenience goods usually strive to make their products compare favorably on price and quality bases.

Seeking to minimize shopping time and effort, the consumer buys convenience goods at "convenient" locations. While this often means that the consumer buys many convenience goods at retail outlets situated near his home, it can mean other things. A consumer may buy gasoline, for example, not at the station nearest his home but at a more convenient station, because he passes it on the way to work. Or the consumer may patronize a given service station where he can enjoy the convenience of using his credit card and not having to pay cash. In buying certain convenience goods, such as milk and newspapers, some consumers pay higher prices for the convenience of doorstep delivery. Many housewives, motivated by

<sup>15</sup> The definitions of these three classes of consumers' goods used in the following discussion are consistent with those of the American Marketing Association. See: *Marketing Definitions, op. cit.*

the convenience of "one-stop shopping," buy most of their grocery needs on weekly trips to the supermarket. The same housewives "pick up" other items, such as bread and milk, during the week at neighborhood grocers convenient to their homes.

Recognizing that consumers will not go far out of their way to buy convenience goods, marketers of such goods seek to have them available for sale in numerous and diverse outlets. Cigarettes, for example, are sold in practically all grocery stores and drug stores, most restaurants, and many service stations, besides being widely available for sale through vending machines elsewhere. The makers of Camels cigarettes once, in a famed advertising campaign, promoted the "I'd walk a mile for a Camel" slogan implying that Camels were not a convenience good. Probably there are relatively few smokers who regard their brand so highly that they will not accept a convenient substitute should the retailer be sold out of the preferred brand. This underscores the importance to the marketer of convenience goods of not only having numerous outlets for his product but being certain that all have adequate inventories on hand.

**SHOPPING GOODS.** Items that the consumer selects and buys only after making comparisons on such bases as suitability, quality, price and style are called shopping goods. Whenever a substantial number of consumers habitually make such shopping comparisons of an item before they select and buy an item, that item is considered a shopping good. Examples of goods that most consumers probably buy in this way include millinery, furniture, rugs, dress goods, women's ready-to-wear and shoes, and household appliances. Prior to buying these items, the consumer shops around and compares the offerings of different stores. Notice that the typical shopping good is bought rather infrequently, is "used up" quite slowly, and the consumer often is in a position to defer or advance the date of purchase. Thus, the consumer can afford to allot a considerable amount of time and effort to the buying decision. In other words, consumers feel that the possible gains from making shopping comparisons exceed the costs in terms of time and effort.

Not every consumer uses the same bases of comparison in buying shopping goods. In some cases, the consumer shops primarily to find something "suitable," e.g., the person who looks for window shelving to use in displaying African violets. In shopping for millinery or apparel, some women consider style the most important factor while others are mainly "price shoppers." In shopping for shoes for their children, these same women may consider quality the most significant basis for comparison. The bases of comparison used and their relative importance vary both with the product and the shopper.

Branding is a good deal less important for shopping goods than for



convenience goods. Rather than buying a modern chair on the basis of a brand name, most consumers prefer to compare different offerings on other bases. But this does not mean that branding is unimportant, only that it is less important as a buying influence than it is in buying a convenience good such as cigarettes or tooth paste. If a shopping good, such as a modern chair, meets the consumer's other qualifications, he may decide to buy the *Selig* chair rather than an unbranded chair or a little-known brand. In some instances the consumer undoubtedly is willing to pay more for a branded shopping good, but the more definitely a good is a shopping good, the less he is willing to pay for the prestige of the brand name.

Because consumers typically devote considerable time and effort to the buying of shopping goods, marketers of shopping goods can manage with fewer retail outlets for their products than can marketers of convenience goods. The shopping goods marketer places great emphasis on having his goods for sale in outlets where consumers are likely to look for such items, rather than on having them available in every store. Thus, a manufacturer of modern chairs seeks only a few furniture stores, mostly those specializing in modern furniture, to handle his line in a city.

**SPECIALTY GOODS.** Consumer items for which significant numbers of buyers are habitually willing to make a special purchasing effort are known as specialty goods. For an item to be included in this category, it must possess unique characteristics or have a high degree of brand identification or both. Examples of articles usually bought as specialty goods are fancy foods, hi-fi components, stamps and coins for collectors, and "prestige" brands of men's suits. The consumer already knows the product or brand he wants, the special purchasing effort he is willing to make is for the purpose of finding where it is on sale. In reaching the buying decision, consumers do not compare the desired specialty good with others as they do in the case of shopping goods. However, as specialty goods are often in the luxury price class, consumers may take considerable time in making decisions to undertake the special search required.

Specialty goods may be found in low as well as high price ranges. The buying behavior of stamp collectors, for instance, is characterized by the exertion of nearly as much special purchasing effort to obtain the missing stamp in a set worth a dime or a quarter as it is to locate the rarity worth hundreds of dollars. Similarly, the price of canned, chocolate-coated grasshoppers may be \$1.00 per can and the price of a *Hickey Freeman* suit may be \$200.00. But while the amount of money involved is low in one case and high in the other, both prices are high relative to other articles serving the same basic wants but without the unique characteristics of chocolate-coated grasshoppers or the prestige attached to the

*Hickey Freeman* name. Consumers are willing to exert special purchasing efforts to locate such items, and *prices* are only secondary considerations in the buying decisions.

Even though an item may be easy to locate, that fact alone does not disqualify it from being a specialty good. The consumer desiring a *Hickey Freeman* suit, for instance, needs only to consult the classified section of the telephone directory in any major city. The consumer who wants to buy *Alka-Seltzer* and will not accept a substitute probably can find it in most drug stores and many grocery stores. An item is a specialty good because some buyers are *willing* to make a special purchasing effort, although they may not have to. Marketing practices of many manufacturers of specialty goods have made it unnecessary for consumers to exert special purchasing efforts. They have made their brands relatively easy to locate, thus making it easy for consumers to buy them.

APPRAISAL OF "TRADITIONAL" CLASSIFICATION SYSTEM. Under this three-way classification system, every consumer product may, at least in theory, be placed into one of the three classifications. For products classed as convenience goods or shopping goods, this proves relatively easy to do. But, perhaps because of insufficient knowledge of consumers' buying attitudes, items coming under the specialty goods heading are difficult to identify and classify as such. Many specialty goods are easily confused with shopping goods and sometimes even with convenience goods. The buyer of a *Chevrolet* automobile, for example, may have made his choice only after comparing the *Chevrolet* with other makes, or perhaps he bought it because of certain unique features and the brand name, or maybe he bought it because of the dealer's convenient location. In the first instance the *Chevrolet* qualifies as a shopping good, in the second as a specialty good, and in the third as a convenience good. There are in fact many border line cases of consumer products which simply cannot be placed with absolute certainty. This often makes it difficult to apply the three-way classification system to the analysis of practical marketing problems.

#### *The "Characteristics of Goods" Theory*

The characteristics of goods theory, advanced by Leo V. Aspinwall and other marketing experts, provides an alternate method for classifying consumer goods. According to this theory, it is possible to spot all consumer goods along a continuum which has only two basic categories, one at each end. Any product that falls somewhere in between these two categories represents some combination of the two basic types.<sup>16</sup> This ap-

<sup>16</sup> We are indebted to Professors Leo V. Aspinwall and Richard H. Holton for their thinking and writings on the classification of consumer goods. Our discussion is based largely on what these two marketing experts have published. See: Leo V. Aspinwall,

proach, therefore, uses a continuum instead of discrete classes to classify all consumer goods. The result is less confusion in classifying individual items. The discussion which follows is intended to detail the new approach.

Five marketing characteristics of a good are taken into account in deciding just where it should be spotted along the continuum. The first, Aspinwall calls the "replacement rate," which is defined as the rate at which a good is purchased and consumed by users in order to provide the satisfaction a consumer expects from the product. The second is the "gross margin" which is usually defined as the money sum which is the difference between the laid-in cost and the final realized sales price. The third characteristic is "adjustment," which refers to the various changes or alterations made in a good in order to meet the exact needs of the consumer. The fourth characteristic is known as "time of consumption," which is defined as the measured time of consumption during which the good gives up the utility desired. The last marketing characteristic considered is that of "searching time," which is defined as the measure of average time and distance from the retail store and hence convenience the consumer is afforded by market facilities.

At one end of the continuum are placed those products which have a high replacement rate, low gross margin, low adjustment, low time of consumption, and low searching time. With little damage to existing definitions, such products appear to be the same ones which are considered convenience goods under the older system of classification. Products with diametrically opposed marketing characteristics go at the other end of the continuum. These items correspond with those defined earlier as shopping goods.

Still to be considered are those consumer products which fall somewhere toward the center of the continuum. These are products, many of which would be called "specialty goods" under the older three-way classification system, which have medium ratings for the five marketing characteristics mentioned earlier. Aspinwall avoids the confusion inherent in the older system by adopting a new set of names for the different classes of goods. Instead of using such terms as convenience, specialty, and shopping goods, new names based upon colors are advocated for the classification of consumer goods. By using three colors (red, orange, and yellow), the notion that discrete classes for consumer goods exist is discarded. In its stead is envisioned the idea of an infinite graduation of values made possible by blending the colors in the spectrum from red to

yellow with orange in between. In effect, convenience goods now become "red goods" and shopping goods become "yellow goods." Goods that fall on the continuum between the two extremes are represented by some shade of orange and are denoted as "orange goods." Chart 2.1 shows the classification system for consumer goods established according to the characteristics of goods theory. One additional aspect of this theory needs to be mentioned here. It is that the position of a good on the color scale is dynamic rather than static. In the words of Aspinwall: <sup>17</sup>

... Most products fall in the yellow classification when they are first introduced. As they become better known and come to satisfy a wider segment of consumer demand, the replacement rate increases and the good shifts toward the red end of the scale. Thus there is a red shift in marketing which offers a rather far-fetched analogy to the red shift in astronomy which is associated with the increasing speed of movement of heavenly bodies. There is also an opposing tendency in marketing, however, resulting from the constant shrinking of gross margin as a good moves toward the red end of the scale. Marketing organizations, in the effort to maintain their gross margin, may improve or differentiate a good which has moved into the red category, so that some of these new varieties swing all the way back into yellow. Thereafter the competitive drive for volume serves to accelerate the movement toward the red end of the scale again.

**Chart 2.1**  
**Classification of Consumer Goods**  
**According to the Characteristics of Goods Theory**

<i>Characteristics</i>	<i>Color Classification</i>		
	<i>Red Goods</i>	<i>Orange Goods</i>	<i>Yellow Goods</i>
Replacement Rate	High	Medium	Low
Gross Margin	Low	Medium	High
Adjustment	Low	Medium	High
Time of Consumption	Low	Medium	High
Searching Time	Low	Medium	High

Source: Leo V. Aspinwall, "The Characteristics of Goods Theory," in W. Lazar and E. J. Kelley (Eds.), *Managerial Marketing: Perspectives and Viewpoints* (Homewood, Ill.: Richard D. Irwin, 1962), p. 641.

### *Industrial Goods*

Classification is less difficult with industrial goods than it is with consumers' goods. This is because industrial users exhibit more uniform patterns of buying behavior than do ultimate consumers. Different industrial buyers, in other words, are remarkably alike in the ways they go about making buying decisions for similar products. The approach an automobile manufacturer takes to the buying of machine tools, for ex-

ample, closely resembles those taken not only by his competitors but by other buyers of machine tools. Industrial goods, therefore, readily lend themselves to a classification system based on the uses to which products are to be put. Most industrial goods fall naturally into one of four categories: (1) equipment and physical facilities used in producing goods or services, (2) materials entering into the product, (3) manufacturing or service supplies, and (4) management materials. Each of these categories, together with certain subcategories, is discussed below.

**EQUIPMENT AND PHYSICAL FACILITIES USED IN THE PRODUCTION OF COMMODITIES OR SERVICES.** Included in this category of industrial goods are three subcategories: installations, minor equipment, and plants and buildings.

Major capital assets such as factory turret lathes and commercial laundry dryers are called installations and are essential to the business operations of an industrial user. Since they require the investment of comparatively large sums of money, no decision to purchase an installation may be made without the approval of both top-management and the department head concerned. Because of this "multiple influence" on the purchase, a salesman of installations usually has to convince several individuals before he succeeds in getting an order, the period of negotiation prior to a sale often extending over considerable time. Furthermore, because of the high unit value of most installations, their marketing is characterized by rather "short distribution channels," i.e., there are few or no intervening middlemen between producers and industrial users.

Minor equipment includes industrial goods which assist in the production of the industrial user's product or service. Examples of such goods are work benches, lift trucks, and hand tools. In contrast to the way installations are bought, the purchasing procedure for minor equipment is quite routine, ordinarily consisting simply of the industrial user's purchasing executive ordering on the basis of specifications prepared by the department which submits the purchase order. Also in contrast with installation purchases which are comparatively infrequent, purchases of minor equipment are made fairly often. Thus, the marketer of minor equipment must see to it that his salesmen make frequent calls on prospective customers, also often arranging to have his products listed in industrial catalogs to which purchasing agents refer before placing their purchase orders. Listing in industrial catalogs, advertising in trade journals, and direct-mail advertising make up the usual program for maintaining representation at the buyer's plant between salesmen's calls. This need to have continuous representation also prompts many marketers of minor equipment to use middlemen rather than their own salesmen for

purposes of calling directly on customers. Because he confines his operations to a relatively small geographic area, the middleman is able to make frequent calls on customers and can adjust his activities to fit each customer's buying timetable.

Plants and buildings are necessary to the operation of an industrial user's business and they represent sizable capital investments. In this respect, the plants and buildings subcategory is similar to the installations subcategory. But this subcategory also resembles that of minor equipment insofar as plants and buildings are supplementary to, rather than directly used in, the production of the industrial user's product or service. Plants and buildings are usually not marketed as complete units, though there are some construction firms that specialize in such projects. The plants and buildings subcategory is included here only for the sake of completeness, and not because their marketing is particularly unique. In all major respects, the industrial user approaches the problem of constructing a new plant or building in much the same way that he goes about the purchase of an installation.

**MATERIAL ENTERING INTO THE PRODUCT.** This category of industrial goods includes the subcategories of raw materials, semi-manufactured goods, and fabricating parts.

Raw materials are those basic products of farms, mines, fisheries, and forests which enter into the production of more finished goods. Buying procedures for raw materials vary, depending upon the proportion their costs bear to total production costs and upon market conditions. If the price of raw materials represents only a small part of total production costs, the sources of supply are likely to be middlemen and the buying procedures routine. But when the price of raw materials accounts for a large part of the total cost of a finished good, high-ranking purchasing executives usually deal with suppliers. Similarly, if the market for a raw material is characterized by stable supply and price conditions, relatively low level executives using routine purchasing procedures are adequate. But when raw material supplies and prices vary erratically, highly-skilled and high ranking executives are charged with the buying responsibility and are expected to adapt their purchasing procedures to changing market conditions.

Semi-manufactured goods such as steel, lumber, and glass are the end products of one industry and the basic manufacturing materials of another. Compared with the prices of raw materials, prices of semi-manufactured goods tend to be more stable. Thus, their purchase by the industrial user is of a more routine nature. Inasmuch as most producers of semi-manufactured goods are large, their products are often sold by

the producer direct to the industrial user. In some cases, however, particularly where the semi-manufactured good is sold to many relatively small industrial users, one or more levels of middlemen are used.

Fabricating parts are manufactured goods which, without any substantial change in form, are incorporated into or assembled into some more complex and finished product. Storage batteries, spark plugs, and tires for an automobile are all examples of fabricating parts. Industrial users buy such products, made to their own specifications, directly from the manufacturers. Single sales contracts are negotiated for periods of several months to a year, and the relationship between seller and buyer is generally a long-term one. These negotiations are normally directed by high executives of both buying and selling companies.

**MANUFACTURING OR SERVICE SUPPLIES.** These are products that are essential to the business operations of industrial users but do not become part of the finished product. Included are such divergent items as fuel oil, coal, sweeping compound, and wiping cloths. Purchase of items in this category is a routine responsibility of the industrial user's purchasing executive, and he usually buys them through middlemen rather than direct from the makers. But where an item is used in extremely large quantities, as coal is used in the steam plant generation of electricity by a public utility, long-term purchase contracts, similar to those used in buying fabricating parts, are directly negotiated by top ranking executives of the buying and selling firms.

**MANAGEMENT MATERIALS.** This category covers both office equipment and office supplies. Pieces of office equipment of very high value, such as electronic computers and data processing installations, are usually leased rather than bought outright but, in either case, decisions are reached in essentially the same way that decisions are made on production installations and equipment. Purchase or lease of major office equipment items involves substantial sums of money; hence, decisions require the approval of both top-management and the department head concerned, and the purchasing department merely handles the needed "paper work." Typewriters, desk calculators, and similar pieces of equipment are bought by the purchasing department as needed on requisitions originating in the departments that will use them, often with the exact brands and models being determined according to preferences of typists and clerks. Pencil sharpeners and staplers and other low unit value articles of office equipment, as well as such office supplies as stationery and typewriter ribbons, are bought routinely, the purchasing department taking the initiative in ordering them and generally carrying a stock on hand.

**RECIPROCITY IN INDUSTRIAL MARKETING.** In marketing all classes of industrial goods, the fact that some buying is done reciprocally is a complicating feature. An industrial user practices reciprocal buying when he favors sources of supply who are also his customers or prospects, and when he uses such patronage as a lever for making sales. One purchasing executive described reciprocal buying as "a matter of you scratch my back, and I'll scratch yours." The practice was at one time widely condemned by purchasing executives as a violation of scientific purchasing, inasmuch as product appropriateness and supplier reliability and other considerations tended to take a "back seat" to the factor of present and future sales to suppliers. Oftentimes, too, the industrial user's sales department did not hesitate to put pressure on the purchasing department to favor customers and prospects with orders regardless of other important considerations affecting choices of suppliers. Today there is a more tolerant attitude toward the practice, though there is little doubt that haphazard reciprocal buying represents a departure from rational buying procedures. Marketers of industrial goods, as they study how their customers and prospects go about choosing suppliers, should make certain that the influences exerted by reciprocal buying practices are included in their analyses of market behavior.

### CONCLUSION

Markets and products are two essential components of the marketing process. No marketing transaction can be carried on in the absence of either component. The marketer seldom thinks in terms of the total market, but, instead, in terms of those subcategories or segments that may be able to use his products. Division of the market into the two main categories of ultimate consumers and industrial users is useful because of the differences in buying procedures in the two groups. Further subdivision into smaller segments allows each marketer to define more precisely the potential market for his particular product and to direct his promotional efforts in the most efficient manner to reach that market. In the same manner, the classification of products increases the efficiency of the marketing process. Whereas the buying behavior for all goods varies widely, it is fairly consistent for any single category of consumer or industrial goods.

### QUESTIONS AND PROBLEMS

1. Of what value is a breakdown of markets by industrial users and ultimate consumers, since the same individual, when buying a typewriter for his office is an industrial user, and



when buying a typewriter for his home is an ultimate consumer? Is he really likely to act differently in these two situations?

2. Is an understanding of marketing segments equally valuable in marketing all kinds of goods and services? For example, how would it help a soap manufacturer, an automobile manufacturer, a life insurance company?
3. If a family's income is doubled (increasing from \$5,000 to \$10,000) what would you expect to happen to its relative expenditures for food, clothing, and housing?
4. A retired elderly couple with an income of \$5,000 a year from retirement benefits and social security may have as much buying power as a couple in their twenties with an income of \$8,000 a year. Explain how this might be true. In what different ways would they be likely to spend their income?
5. Would you expect the rural market in the United States to be essentially different from the urban and suburban markets in terms of preferences for clothing, food, and leisure time activities? Are these differences likely to be larger or smaller than regional or geographic differences within like groups, e.g., urban dwellers?
6. Would it be accurate to assume that regional differences in consumer preferences are rapidly disappearing with improved communication and transportation? Explain.
7. Why do lower-education-level families spend considerably more money on cooking, baking, and salad ingredients than college-level families? Do eating habits and income differences provide a complete explanation? Explain.
8. Would the Standard Industrial Classification System provide an equally satisfactory basis for segmenting the market for drill presses as for typewriting paper? Why or why not?
9. Why should San Diego, California, prove to be a more promising market for the products of a Seattle, Washington, lumber mill than Denver, Colorado?
10. If it makes sense to identify different segments of the market as potential purchasers of original equipment and replacements, does it make equally good sense to differentiate these products and use separate salesmen? Explain.
11. Explain how cigarettes might be bought as convenience goods, as shopping goods, and as specialty goods by different consumers. Does this lack of uniformity in classification of goods destroy the usefulness of classifying? Explain.

12. Can you give examples of products which may have been classified as "yellow goods" when introduced and that subsequently moved along the scale to be classified as "red goods"? Can you think of a product that has moved in the other direction?
13. Would you recommend using the same kind of salesman to sell installations as to sell minor equipment? Why or why not? Describe what might be the typical procedure in making a sales presentation for each kind of product.
14. How might the buying procedures differ for a steel fabricating plant buying sheet steel and a shoe manufacturer buying processed hides? In which company would the buying responsibility probably be more important?
15. Describe the differing viewpoints toward reciprocity likely to be held by purchasing agents and sales manager. Would you agree that reciprocity is only the refuge of the weak sales organization?

# MARKETING

## FUNCTIONS

### 3

Marketing is made up of a number of activities known as *marketing functions*. Identifying these functions might seem simple since it would appear necessary only to itemize the various activities required to move goods and services from producers to consumers. However, the difficulty of determining just where marketing begins and ends complicates the task of identifying and classifying marketing functions. Marketing is defined in Chapter 1 as “the business process by which goods and services are brought into contact with markets and through which transfers of ownership take place.” It is a natural oversimplification to assume that marketing activities are

only concerned with the flow of goods and services, but to achieve maximum efficiency in marketing there must also be a flow of information in the other direction—from the market to the producer. This information gathering activity may take place before the product is planned or produced. Thus, it is logical to think of the marketing process as beginning and ending with the consumer, with information flowing from the consumer to the producer and goods flowing back to the consumer from the producer.

Marketing is involved in all business functions. There are no clear-cut lines separating it from production, personnel, and many other business functions. Nor is it ever restricted within a single business enterprise. It overlaps and is spread among producers, other businesses engaged in marketing known as marketing institutions, and consumers. Similarly, the marketing of almost every commodity or service is subject to varying applications of different marketing, and nonmarketing functions and is carried on by diverse groups of institutions.

The activities most easily identified as marketing functions are those concerned with bringing goods into contact with markets. Selling is one of these. Buying, the other side of selling, is not so easy to identify as a marketing function, such identification depending on who is buying. A retail store, for example, is primarily involved in marketing as opposed to producing, so most of its activities are concerned with marketing. The "buying" of merchandise for resale is one of the retailer's most important tasks, for to achieve his aim of selling goods to the consumer, he must buy those things the consumer needs and wants. But, is buying as clearly a marketing function for a manufacturing firm? In some instances, his buying decision is influenced by the effect his purchase has on the marketability of his product; in other instances, it is influenced by the effect on product costs. The selection and purchase of wood for television cabinets mainly affects the marketability of the finished product, but the selection and purchase of metal for the receiving equipment inside the cabinet is for the most part a production problem. In most cases the purchasing agent is influenced by *both* marketing and production needs—so, to most manufacturers, buying is properly looked upon as a marketing function, but one whose performance is frequently conditioned by production considerations.

Activities not directly concerned with bringing goods into contact with markets are more difficult to identify as marketing functions. It is for this reason that manufacturers' buying activities are often considered solely a production responsibility. Marketing is also concerned with product planning and design since a product must be fitted to the needs and desires of the consumer. A manufacturer must discover these needs and desires in an early stage of product development work.

Marketing functions are often performed by the consumer himself. Marketers strive to move goods or services into the hands of consumers, but it does not necessarily follow that all marketing then ceases. For example, storage is normally thought of as a marketing activity. Potatoes, which are produced seasonally, are held and sold throughout the year by marketing organizations, but sometimes individual consumers take over part of the storage function. They may buy bushels of potatoes to store in their basements. The storage function continues to be performed, but it is transferred from marketing organizations to consumers.

### ✓ A CLASSIFICATION OF MARKETING FUNCTIONS

Classification of marketing functions makes it easier to analyze specific marketing situations. Identification of separate activities common to large numbers of businesses engaged in marketing makes it possible to compare and analyze marketing policies and decisions in different organizations. It is of little value to the marketing administrator to learn that the overall marketing performance of his firm is inferior to that of a competitor, because he doesn't know where to start in improving it. But, if he learns that his transportation costs are higher than average, or that his advertising expenditures are excessive in terms of results, he knows where to direct his efforts toward improvement.

No general classification of marketing functions can be used to analyze the marketing situations of all firms. Such a system must first be modified to fit the specific marketing circumstances of any firm. Keeping this in mind, we may classify marketing activities into three categories containing nine functions in all:

#### Merchandising Functions

1. Product planning and development
2. Standardizing and grading
3. Buying and assembling
4. Selling

#### Physical Distribution Functions

5. Storage
6. Transportation

#### Auxiliary Functions

7. Marketing financing
8. Risk bearing
9. Market information

These functions are listed in a logical sequence for purposes of discussion. The merchandising category starts with an analysis of market needs and the development or procurement of products or services to fill these needs and ends with the activities necessary to create a demand for these prod-

ucts and services. The physical distribution category is concerned with the activities necessary to make these products and services available at the time and place where the consumer needs them. The last category includes the supporting activities necessary to the effective performance of the merchandising and physical distribution functions.

### *Merchandising Functions*

Merchandising consists of those activities necessary to make available to the market the products or services that fit the needs of that particular market and to create a demand for these products or services. Establishing standards of product uniformity makes it easier to build consumer demand, so grading and standardizing is also logically included as a merchandising function.

**PRODUCT PLANNING AND DEVELOPMENT.** Consumption and consumer satisfaction are necessary if the marketer is to achieve his goals of sales and profits. A product, to be successfully marketed, must as nearly as possible conform to consumers' or users' needs and desires, and this requires frequent product adaptation. This product adaptation is an endless process in most industries, with improvements in products as a result of research plus changing consumer demands creating continuing product obsolescence. In rapidly growing industries, such as electronics, products developed within the last twenty years normally account for over half of sales and profits of more progressive companies, because the older products experience declining demand and profits leading eventually to obsolescence and cessation of demand. In such industries, the company which does not innovate almost certainly faces gradual elimination from the market. In other industries, in spite of the fact that the rate of product obsolescence may be slower, the same general rule holds true though over longer periods of time.

The marketing executive is assuming an increasingly important role in product planning and development, because he brings to the subject an important viewpoint not shared by other executives. Traditionally, product development has been the responsibility of engineering, technical research, and, to a lesser degree, production departments. Engineers design products which will meet set performance standards, e.g., an automobile engine that will provide a cruising speed of 75 miles per hour and gas consumption of no more than one gallon in twenty miles. Production men modify these designs so that products can be manufactured by the most efficient and economical method that will retain the performance specifications.

But marketing men are concerned with performance only when they are convinced that consumers are too. Consumers often seem more inter-

ested in appearance and so-called "non-essential" external details than they are in performance, which they apparently take for granted. They seem satisfied, for example, that several manufacturers provide satisfactory refrigerators, so in selecting a brand, many are influenced by such "extras" as automatic ice cube makers and revolving shelves. Products with superior engineering and performance characteristics are often rejected in favor of just-adequate products with more attractive design and "extra" features. Some consumers are more interested in superior engineering and performance characteristics and by joining consumer organizations, such as the Consumer Union, they receive information enabling them to make their product selections in a more rational manner. Since these groups comprise a very small portion of the total market, the marketer cannot rely on their business alone to operate profitably. He must still provide the attractive design and "extra" features to attract the mass market.

The growing recognition of the importance of satisfying changing consumer product preferences is shown in many businesses by the trend toward assigning a more important role to the marketing division in the organizational responsibility for product planning and development. For the same reason, middlemen, too, consider product planning and development, which usually takes the form of changes in product lines handled or services offered, crucial to the success of their operations. A grocery wholesaler who begins a cash-and-carry service is engaging in product planning at the wholesale level. A men's clothing store which adds a selection of women's clothing or abandons delivery service is engaged in product planning at the retail level. Both retailers and wholesalers are inclined to call such changes "merchandising," but what they are actually doing is comparable to what manufacturers do under the name of product planning and development. Even the farmer engages in product planning when he switches crops to meet what he believes will be consumers' demands. In replacing string beans with artichokes because of a rise in the demand for artichokes, he is attempting to readapt his output to the changing requirements of the market. The decision to change products and product policies usually results from the acquisition of new information about the market. Thus, the market information function, to be discussed later in this chapter, functions hand-in-hand with product planning and development. In a like manner, all of the functions are interrelated.

**STANDARDIZING AND GRADING.** Standardizing and grading involve the establishment of basic measures or limits to which articles must conform. A standard consists of the specifications or basic limits to the qualities or characteristics that products must have to be of designated grades. Standards should be based on the qualities desired by buyers or on the

use to which the article is to be put. For example, in the manufacture of clothing it is useful to establish standards of size so that all size-12 dresses will fit the same individual. Grading is the act of separating or inspecting the goods according to the established specifications to determine their grade. The specifications are set by the standards established and may include size, weight, color, quality, etc.

Standardizing and grading are important to efficient marketing. Both facilitate the buying function by making it possible for buyers to purchase by description, e.g., ordering a ton of steel or coal of a specified grade by mail or by telephone. The only alternative to purchase by description is for the buyer to go to the seller's warehouse and examine the goods before purchase or to ask the buyer to send him a sample of each lot of goods before he makes his buying decision. Both standardizing and grading facilitate the selling task by making it possible to "merchandise" products closer to just what consumers and other users want. A mixed lot of ungraded fruits is less attractive to prospective customers and commands a lower total price than the same lot after it has been graded and priced by grade. Also, consumers of both agricultural and manufactured products return again and again to buy these products which consistently meet their needs. Grading also helps in streamlining the physical handling of many farm products, since it makes it possible to mix the property of different owners for purposes of storage and transportation. This characteristic of graded goods permits the grain elevator operator to store the crops of different farmers in a single elevator, and it allows the transportation company to mix the same crops in shipment.

"Standardization," the use of standards, is applied to manufactured goods. The first step in standardizing involves the establishing of certain physical standards to which the product should conform. For the individual manufacturer, management must decide on standards for the product, and then set controls over the manufacturing process so that the goods meet the standards within set tolerances. A farmer who can do little to control the physical characteristics of his product, uses grading primarily as a means for describing his product accurately. But a manufacturer who can control product specifications must start with an assessment of the market before selecting standards to which he wants his product to conform. With the system of standard sizes established for shoes, the shoe manufacturer is able to plan his production accordingly. He can measure the potential market for each shoe size and produce each in proportion to the probable demand, or he may decide to produce only certain sizes.

"Grading" refers to the application of basic descriptive standards, such as size, color, or weight, to the products of nature, where growers or producers have very limited control over their products' physical specifications. Orange growers, for example, find that they cannot produce oranges



which are all uniform in size. Proper thinning increases the average size of the oranges, but the range of individual sizes will still be very wide. Since the United States Department of Agriculture has set standards for the sizes and grades of oranges, growers can now sort their crops according to these sizes and end up with oranges in each of several sizes or grades each of which will command a higher price than the ungraded fruit. This is only one example of grading. Grades may be established for other physical properties of natural products, but for grading to be used, all such properties must be measurable. Thus, canned peaches can be graded in terms of properties such as sugar content, color, and size, but they cannot be graded in terms of taste, because there is no objective way of measuring differences in individual standards of taste. Grading not only facilitates the marketing tasks of producers, as described earlier in this section, but it also makes it easier for consumers to identify the specifications of the products which they buy.

Standardizing is most effective when it is adopted on an industry-wide basis. Otherwise, a consumer may not safely expect a size 9 to be the same no matter which company made it. Trade associations and government agencies are responsible for securing the adoption of standards. Standardization in each industry is normally carried out on a voluntary basis, and there are some industries which still have not adopted standards. Although there are many farm products, such as tobacco, which do not lend themselves easily to grading, because the product characteristics important to the consumer cannot be measured objectively, grading and standardization are widespread in American business today.

**BUYING AND ASSEMBLING.** Buying, as a marketing function, is the procurement of goods or services for eventual resale to the consumer or industrial user. Goods purchased by the producer are used in the manufacturing process and usually reach the consumer or user in different form as a part of the finished product. Goods purchased by middlemen are resold in essentially the same form to other middlemen or the consumer or user. Another important part of the buying function is assembling, bringing together a wide variety of goods for resale by a single establishment, or bringing together a large amount of similar goods of many producers from a broad geographic area for resale in a single region. Assembling is performed primarily by the middleman. For example, the products of many small farmers from different sections of the country are assembled by centrally-located wholesale distributors who distribute them to smaller regional wholesalers for eventual sale by retail grocers to ultimate consumers. Similarly, large retail outlets such as department stores and supermarkets assemble the products of many manufacturers and producers so that consumers can satisfy a variety of needs on one shopping trip.

Successful buying requires an ability to estimate the consumers' needs and desires weeks and even months in advance. Ordering merchandise that will be delivered and placed on sale two or three months later, manufacturers and middlemen are in effect trying to anticipate what consumers will do in the future when the consumers are not sure themselves. Businessmen expect to make a certain percentage of buying errors and allow for this in the original price they place on merchandise. But, if the margin of error is too high, the loss from price reductions may wipe out the business. Under these circumstances it is important that a manufacturer or middleman understand the theory of purchase probability. This theory holds that the number of prospective customers varies with the variety of assortment of any given item.<sup>1</sup> For example, the more brands of coffee a grocer stocks, the more coffee purchasers he is able to attract. But, the potential increase in income from a wider assortment must be balanced off against the added cost of stocking such merchandise. If the grocer stocks ten brands of coffee, he will be able to satisfy the preferences of nearly every customer. If he only stocks the five most popular brands, he may lose fifteen to twenty per cent of the potential sales, but his investment in merchandise will only be half as much. He must, therefore, balance the expected income from the sales of each item added to the assortment against the added costs to determine the optimum assortment.

It is important for a businessman to know his customers' needs and buying habits so that he can accurately predict their buying actions. A retailer must have knowledge about the consumers who comprise his market, their income levels, their product preferences, their shopping habits, etc. A wholesaler, who is one further step removed from ultimate consumers, must have just as complete an understanding of his own customers, the retailers, and at least a general knowledge about their customers to perform his own buying job successfully. Similarly, the manufacturer must be familiar with the buying habits, financial needs, promotional policies and other such information about his own immediate customers, but he must also be acquainted with the needs and buying patterns of other marketing intermediaries further removed down the distribution channel and finally the ultimate consumer at the end of that channel.

The importance of buying and assembling varies widely with the different marketing institutions. To a producer, it is often less important than other marketing functions since the marketability of his goods depends to a much greater extent on product design and good manufacturing than upon the materials that are used to produce his product. But, since the quality of raw materials affects the quality of a finished product, a manu-

<sup>1</sup> For a detailed discussion on the probabilities of purchase, see: F. E. Balderston, "Assortment Choice in Wholesale and Retail Marketing," *Journal of Marketing*, Vol. XXI (October 1956), pp. 175-183.

facturer must buy these materials with an eye to consumers' demands. Even farmers must select their seeds and growing stock with consumer preferences in mind. It is to the middleman that buying assumes its greatest importance. Since he resells the products he buys in the same form, it is only through his performance of the buying function that he can satisfy the demands of his customers. Department stores attach so much importance to buying that their merchandising executives usually are known as buyers, even though these executives are normally responsible for both buying and selling. In retailing high style or fashion merchandise, skill in buying often determines ultimate success or failure. The department store buyer who overestimates the acceptance of a new fashion by his customers may find himself at the end of the season with a large stock of dresses that must be liquidated at less than cost. Added to this direct loss is the loss of potential sales that would have been made if the same money had been invested in acceptable merchandise. Such mistakes, if repeated very frequently, will cause bankruptcy. Retailers have an expression which sums this situation up: "Goods that are well bought are already half sold."

**SELLING.** Selling, in its broad sense, aims not just at making sales but also at finding buyers, stimulating demand, and the providing of advice and service to buyers. If a marketer is to reach these selling goals, he must be able to effectively combine such activities as advertising, sales promotion, packaging, personal selling, and customer service. Although some marketers will rely on just one of these activities, most realize that the best results come from some combination of several activities.

*Advertising.* Because advertising generally is a relatively low-cost method of conveying selling messages to large numbers of potential customers, it plays an important role in the majority of sales programs. Advertising is used not only as a method of stimulating demand but for many other purposes. It can secure leads for salesmen and middlemen by providing a handy way for the reader to write in for more information and by listing sources of supply in each territory. It can force middlemen to stock the product by building consumer interest. It can educate dealers' salesmen in uses and applications of the product. And it can build dealer and consumer confidence in the company and its products by building familiarity through repetition.

Marketing management's most frequent assignment to advertising is to stimulate market demand. By using advertising to "pre-sell" customers, that is to arouse and intensify their interest in advance, marketing management hopes to facilitate the selling task of the personal sales force. Advertising, when used as the only selling method, seldom can be relied on to consummate sales in sufficient volume to justify the expenditures in-

curred. However, skillful advertising may succeed in achieving consumer acceptance or preference, or even demand for the product. Advertising, then, must usually be used with at least one other form of selling, such as personal selling or point-of-purchase display, which are more effective in the direct stimulation of prospective consumers to buying action. Good advertising may arouse a consumer's interest, but it will rarely send him to retail stores actively seeking the product. When he is in a store, and his attention is called to the product through an effective display or the advice of a sales clerk, the previous impact of advertising will help persuade him to make a favorable buying decision.

*Sales Promotion.* Sales promotion consists of those selling activities which both supplement and coordinate personal selling and advertising, helping to make them more effective. Examples of these are displays, shows and expositions, demonstrations, and other unusual, non-recurrent selling efforts. Thus, the main purpose of sales promotion is to impel on-the-spot buying action by prospective customers. As might be expected, such devices are used more widely in consumer marketing than in industrial goods marketing. Perhaps, the main explanation for this lies in the fact that ultimate consumers seem to be more susceptible to making purchases on an impulse basis. There is no doubt that a well-designed placard used with a product display, or a special display rack designed to hold a product which is otherwise difficult to display, not only succeeds in attracting customers but often causes them to buy. Placards and displays are also used to provide customers with information about the product. With the development and growth of self-service retailing, consumers have come to depend less on sales clerks and more on sales promotional devices as sources of information.

*Packaging.* Marketing management expects the package to attract consumers' attention at the point of purchase, to furnish consumers with needed information about the product, and to provide the extra push which is so often required to propel consumers into buying. With the spread of self-service retailing, packaging, too, like sales promotion, has expanded in importance as a marketing activity. Management once considered packages significant only as containers for their products and assigned sole responsibility for the packaging activity to manufacturing departments. The basic purpose of a package is still to serve as a container but now management also expects it to play various marketing-type roles which resemble those played by sales promotion devices. Especially where a product is retailed through self-service outlets, a package, like a promotional display, relates the product to the manufacturer's advertising and makes the consumer aware of its availability in the retail store. In self-service retailing, salesmen are responsible for persuading retailers to stock

the manufacturer's product; advertising is intended to make prospective consumers aware of the product, its uses, and its advantages, and packaging skill serves as a tie-in between the efforts of the salesmen and the accomplishments of the advertising.

*Personal Selling.* Personal selling continues to provide the chief means through which marketing programs are implemented. Usually, advertising and other sales methods supplement personal selling. In some situations, such as in selling life insurance, sales can be made only through person to person contacts in which it is possible to fit an on-the-spot sales message to the special needs of each customer. Ordinarily, however, personal selling is the most costly way of making sales, since large investments are necessary to recruit, train, pay, and supervise salesmen, and to provide for their expenses in the field. Marketing management, at least in theory, should use advertising and other more economical sales methods up to the point where their marginal efficiencies are equated with that of personal selling. Thus, although the cost of each advertising message per person contacted is much lower than the cost of each personal sales contact, it may take a very large number of repetitions of an advertising message to motivate a customer to buying action, and it might take only a single good sales talk to do the same. Usually, the least expensive selling job is achieved through some combination of personal selling and other promotional methods.

*Customer Service.* As a selling activity, customer service provides assistance and advice to customers on such matters as product installation, operation, maintenance, and repair. For the prospective buyers of many products, availability and adequacy of customer service is a major factor in choosing among competing sellers. Thus, by providing superior customer service facilities, a seller may be able to obtain the patronage of certain buyers even in the face of strong price competition. As more and more technical features are added to a product and it becomes more complicated to install, operate, and maintain, the element of customer service becomes more important as an instrument of competition among sellers.

It should be re-emphasized that marketing management does not usually depend on just one of these selling activities, but rather tries, through continuous experimentation, to determine a most favorable combination of all of them. (A blend of selling activities into a coordinated sales program is called a promotional mix.) The most favorable, or optimum promotional mix varies with different institutions; it even varies for the same institution at different times. The promotional mix for any company must be designed to fit the characteristics of that company and its changing marketing situation. A marketing manager must be skilled not only in planning an optimum promotional mix, but in coordinating the different selling activities so as to obtain maximum profits.

*Functions of Physical Distribution*

Storage and transportation are the functions necessary to move goods from the time and place of production to the times and places of consumption. These two functions are normally performed together, and managerial decisions on either transportation or storage must be made in view of their effect on the other function. For example, a retailer may find that he can reduce transportation costs considerably on standard items by purchasing them less frequently and increasing the amount of each purchase sufficiently to make up a full carload, because the railroad rates for a full carload are considerably lower per pound or cubic foot than for partial carloads. Yet, to determine whether there is any net saving this retailer must balance the reduction in transportation costs against the increase in storage costs from purchasing in larger quantities.

As the industrial organization of a society becomes more complex, and, as it reaches higher stages of economic development, the marketing functions of storage and transportation become more important. In a highly developed and complex society, such as in the United States, most of the producer's customers are located hundreds and even thousands of miles away, and goods must be transported to, and stored at points which are more accessible to these customers. In countries at a high stage of economic development, such as the Western European countries and the United States, most manufacturers produce in anticipation of market demand and store these goods until they can be sold, whereas those in underdeveloped countries customarily wait for an order before they begin manufacturing and have no need to store finished goods, although they may have to maintain minimum stocks of raw materials. In the most simple and most underdeveloped economies, goods are made primarily for the personal consumption of the producer and his neighbors. When the maker sells his goods in societies of this sort, the buyers are usually the ones who perform the transportation and storage functions.

**STORAGE.** Since, in our complex economic system, goods are usually produced in anticipation of actual market demand, the storage function must be performed. This means that manufacturers, wholesalers, and retailers all must hold stocks, or inventories of goods, until a consumer demand arises. When consumers buy goods from retail outlets, retailers' inventories are reduced and must be replenished from wholesalers' inventories which also must, in turn, be replenished from the manufacturer's inventory. Similarly, the consumer's own stock of goods is reduced by his own consumption and replenished by his purchases. When there is a demand for a good, stock levels fluctuate all along the line of distribution.

This constant storage-in-anticipation is unavoidable for another reason.

The American consumer, accustomed to convenience, insists on an immediate availability of many kinds of goods. But at the same time, he has neither the storage space nor the desire and ability, generally, to pay for more goods than he can use in a short space of time. So, since the only alternative to his holding the goods until he needs them is for him to buy them just before he is ready to use them, someone must store the goods until he is ready to buy. That function must fall to the middlemen and producers who await his convenience.

In addition to the basic reason given above, marketers have three other main reasons for holding goods in storage. Goods are stored to even out seasonality in production or in sales. A manufacturer of Christmas ornaments only has a market for his goods for a few weeks before Christmas, but he may find that his production costs are lower if he divides his production equally throughout the year, storing the inventory of finished goods until the selling season. Similarly, many farm products are harvested in only one season but are consumed throughout the year, so they must be stored from one producing season to the next. Another reason for holding goods in storage is to obtain economies in other business operations. Manufacturers who make products of many sizes, like nuts and bolts, may use the same machines to produce a number of sizes, and they often find it most economical to schedule long production runs involving several weeks' supply of each size at a time, instead of manufacturing the total needs of each size weekly. A third reason for holding goods in storage is to improve their quality and value. Products such as cheese, whisky, and tobacco must be aged or conditioned to improve their flavor.

Speculation, or holding goods in anticipation of price rises, is still another reason for holding goods in storage, although it is not purely a marketing reason. A large proportion of the trading in some commodities is carried on by speculators who have no need for the goods but who hope to profit from anticipated price changes. The fact that goods are held in storage for purposes of speculating affects the demand for certain products and, hence, also prices. Consequently, speculation is of considerable interest and importance to marketing men.

**TRANSPORTATION.** Transportation is a necessary function of marketing, because most markets are geographically separated from production areas. Many large factories are purposely located away from densely populated urban areas to avoid population and traffic congestion and high land costs, with the expectation that the lower costs in the nonurban location will more than compensate for the cost of transporting the goods to urban markets. Other manufacturing plants are separated from their most important markets because of historical accident. The founder of a business may

have started in his own home town, and as he prospered and grew, he moved ever farther from the factory to find new markets for his expanding production facilities. Eventually, he may have built new plants nearer his more distant markets, but under similar conditions other manufacturers have discovered that they could save more in production cost in a single large plant than they could save in transportation costs by locating a number of small plants near the markets. In other industries, such as lumber and steel, where the costs of transporting the raw material are much higher than for the finished goods, manufacturing facilities are located near the source of raw materials with little regard for the location of markets. These examples help to explain why transporting goods to markets is an important function of the distributive organization.

Goods are sent to market in a number of ways, the most important of which are rail, truck, air, water, and parcel post. No single method is best for shipping all goods under all circumstances. The importance of speed in getting the goods to market must be balanced against the cost of faster transportation. A company may, under different conditions, use different kinds of transportation to ship the same merchandise. Often, large organizations which can afford the services of experts will set up separate traffic departments with full responsibility for the transportation function. In all instances, however, the way the transportation function is performed remains a matter of vital importance to the marketing manager.

#### *Auxiliary Functions*

The remaining marketing functions are classified as auxiliary functions, because, although they are not directly involved in the transfer of ownership of goods and services, they help out or are involved in carrying out the other functions. Included in this category are marketing financing, risk bearing, and market information. Because of the relationships they bear to the formulation of marketing and other basic business policies, top-management often pays closer attention to these functions than it does to others.

**MARKETING FINANCING.** The marketer is concerned with finance both as a receiver and as a source of credit. As a receiver, he sometimes has to use short-term financing to tide his business over seasonal peaks which may require additional investment in inventory and higher promotional expenses. Some retailers increase their inventories of merchandise 50 per cent or more above average during the two or three months before Christmas and increase their sales force and advertising expenditures accordingly. If the permanent capital investment is maintained at a level high enough to meet these seasonal needs, much of this money would lie un-



productive the remainder of the year. Consequently, most businessmen prefer to finance seasonal variations in expenses through credit. The financing and storage functions are closely related since large-scale storage, such as is provided by grain elevators, usually creates a need for additional financing. In such instances, the business organization is a receiver of credit.

Marketing organizations have two main sources of credit: trade credit and banks. Trade credit, an important source of short-term financing, is the credit extended by suppliers on the merchandise they sell. Manufacturers and middlemen offer their customers credit terms allowing them from as little as ten days to as much as 120 or more days in which to pay for their purchases, depending on the industry. Trade sources are usually more willing to assume greater credit risks than banks, but trade credit is also the most expensive. For this reason, most marketers consider banks their main source of credit. General financial institutions, such as banks, carry most of this credit load, but some specialized financial institutions have evolved to meet special marketing needs. One such institution is the factor, which serves marketers in several industries but is most important in the textile trade. The factor is a financial institution that provides credit by lending money on accounts receivable from customers, or provides cash by purchasing the accounts outright.

Providing credit to customers is essential to the success of most marketing institutions. A high percentage of retail sales of high-priced durable goods, such as automobiles and furniture, is made on the installment plan. Surprisingly few consumers are both willing and able to pay cash for such items, and there is no doubt that installment credit has made it possible for many more consumers to purchase such merchandise. Department stores and a number of other types of retailers use credit (usually charge accounts) as a powerful device for attracting patronage. At the wholesale level of distribution, most transactions are made on a credit basis. Mercantile credit, which is credit granted by manufacturers and wholesalers, not only assists in but greatly simplifies the transfer of goods, for by extending this credit to buyers, the seller avoids the complications involved in having independent shippers make collections on delivery and the embarrassment of asking customers to pay at the time they place their orders.

**RISK BEARING.** Marketing risks arise from changes in supply and demand, and from natural hazards. Any institution that carries an inventory (i.e., holds goods in storage) takes the risk that demand and supply conditions may change. Thus, marketers who perform the storage function also perform not only the financing function (by taking ownership of the goods) but the risk bearing function as well. Deciding on the proper size of an inventory is a problem of all marketing institutions. There is always

the risk that the inventory will not be sold if it turns out to be too large in relation to market demand. But if the inventory proves to be too small, orders will be lost because they cannot be filled.

A marketer may transfer part of his burden of risk, eliminating some risks entirely and converting others from unpredictable amounts of potential to known items of expense. When a seller agrees to reimburse a buyer for any drop in the price of the product that may occur within a given period, a buyer succeeds in transferring to the seller the entire risk of a price decline during this period. Hedging provides another way to transfer the risks of changing prices in a limited number of commodities traded on organized commodity exchanges. Its use depends on the existence of futures trading, contracts for sale of goods at specified future dates, on these exchanges. Hedging is a procedure involving simultaneous sales in the futures market when purchases are made in the current (spot) market and simultaneous purchases in the futures market when sales are made in the current market, so that losses or profits on current transactions are approximately balanced off against the opposite experience in the futures market.

Risks attached to such natural hazards as fire and floods, deterioration of goods in storage, or damage in transit, can often be transferred to institutions which specialize in assuming such risks. Insurance companies make a business of covering all these risks in return for the payment of premiums. When risks are transferred in this way, unpredictable amounts of potential loss become, as we have said, known amounts of expense.

Since many marketing risks cannot be transferred, marketers concentrate on trying to reduce them. Risks of changes in market demand may be reduced through intelligent sales forecasting and marketing and motivation research. Although the techniques available for measuring potential markets are still far from being foolproof, a well considered sales forecast can help to reduce the margin of error when inventory size is being decided. Also, the risk of a change in market demand may be reduced through an aggressive program of advertising, promotion, and personal selling. Reasonably accurate sales forecasting should also be helpful in reducing the "supply" risk of being out-of-stock and unable to fill customers' orders. Other risks involved in changing supply conditions, such as the risk that an oversupply will cause competitors to cut their prices, may be partially offset by differentiating the products (i.e., by building consumer loyalty for a particular brand in preference to similar products) in such ways that consumers will be reluctant to accept substitutes. To the extent that a policy of product differentiation succeeds, a marketer has a degree of control over the supply, because his customers will be unwilling to change to substitute brands because of a small price differential. In a limited sense he has gained a monopoly control over the supply of the prod-

uct. However, product differentiation is a method of reducing the risk of price competition and not of eliminating it. Few marketers ever succeed in completely differentiating their products.

**MARKET INFORMATION.** Since marketing managers must serve the needs of consumers and users to achieve their ultimate profit goals, their activities should always be market-oriented. In formulating policies and directing marketing activities, a marketing executive must be adequately informed not only about his company's operations, but also about the market for his products. Nearly everything that a marketing executive does, or fails to do, affects both the business and the market. In making marketing decisions, a marketing executive must keep one eye on the market and the other on the company. To a great extent, the success of a company's marketing operation depends on its marketing executive's ability to evaluate such things as the size, location, and characteristics of different markets for the product; the nature of present and potential consumers making up various segments of the market, their needs and desires, and their buying habits and preferences; competitors' strengths, weaknesses, activities, and plans; and trends in market supply and demand. A marketing executive takes this sort of information, appraises its significance for the business, and guides himself accordingly.

In addition to the general types of market information mentioned above, there are particular items of market information which are often extremely important. For example, the fact that there is a "market glut" for lettuce at Chicago is important to a Texas grower planning to ship carloads of lettuce to that area. Similarly, knowing whether Japanese steel producers are successful in supplying Pacific Coast steel users is important information to a domestic steel company which is planning its transportation, storage, selling, and financing. Likewise, an upstate New York manufacturer of room air conditioners must learn as soon as possible of the development of a "run" on his product in the Washington, D.C., market. Items of market information such as these are sometimes called "market news" items to distinguish them from other items of market information. Items of market news have immediate and often momentary implications for a marketer, whereas other more general items of market information have a long-range and continuing significance for him.

Marketing executives gather market information in many ways. Much of it is obtained rather informally through casual conversations with other businessmen; from reading business and trade publications, "syndicated" market news letters, and daily newspapers; from newscasts, and from reports sent by salesmen and sales executives in the field. More formal methods of gathering information are used for obtaining market information of more long-range significance. The methods of sales analysis are applied in combing company records for information about the customers and

markets. Marketing research is used to tap sources of information which lie outside the company. Economic and business forecasting tries to secure important items of information with regard to future market conditions. An effective marketing executive knows how to make full use both of informal and formal information-gathering methods. He must also be expert in interpreting the significance of the gathered information so that the company may use it to maximum advantage.

#### *Variations in Classification of Marketing Functions*

Although the establishment of a systemized classification of marketing activities assists in studying marketing and its problems, there is nothing sacred about any one system of classification in analyzing the activities of a specific firm or industry. For a perfume manufacturer, packaging and advertising may be so important that they deserve to be classified as separate marketing functions while storage may be so unimportant that it does not deserve such separate classification. An example in reverse is that of a retailer who attaches considerable importance to storage and hardly any to packaging. Each marketing institution can benefit from setting up its own classification of marketing functions emphasizing those activities which are important to the success of the business, and de-emphasizing those activities which are less important. Each business must have certain goals, and the list of functions is simply a description of the activities necessary to reach these goals.

If the numbers and kinds of functions required vary with the producer, the product, and the method of distribution used, we may reasonably ask whether it is meaningful to classify into general groups functions which are performed under many sorts of varying circumstances. Certainly farmers, unlike manufacturers, cannot change the design of their products to meet consumers' changing needs and desires. Melon farmers are aware that consumers would prefer seedless watermelons, but are unable to develop such products themselves. They can only hope that plant scientists will eventually develop such products. Hence, farmers have little practical interest in product design. Despite such variances, different institutions still share enough in the way of common aims and activities to permit generalizing about marketing functions.

The differences apparent in the lists of marketing functions put forward by marketing writers reflect this variation in business goals.<sup>2</sup> Most writers include much the same activities as functions or subfunctions. The differences among the classifications presented by marketing writers lie in the varying emphasis which is placed on certain activities.

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<sup>2</sup> For some lists of functions see: T. N. Beckman, H. H. Maynard, and W. R. Davidson, *Principles of Marketing*, 6th ed. (New York: Ronald Press, 1957), p. 35; and P. D. Converse, H. W. Huegy, and R. V. Mitchell, *The Elements of Marketing*, 6th ed. (Englewood Cliffs, N.J.: Prentice-Hall, 1958), p. 140.

### PERFORMANCE OF MARKETING FUNCTIONS AND MARKETING EFFICIENCY

Some marketing theorists believe that repetition in the performance of marketing functions is a sure sign of marketing inefficiency. This is not necessarily so. Some functions must be repeated at each step in the channel of distribution. For example, buying and selling functions may be performed several times since, in the distribution of a product, each middleman customarily both buys and sells. But, finding in this reason a further example of inefficiency, these theorists suggest that marketing costs could be reduced if certain middlemen were eliminated. If this line of reasoning is followed to its logical end, direct sale by producer to consumer would be the most efficient distribution method. In some instances, of course, as in the marketing of certain industrial goods, direct sale is the most efficient distribution method. But in most marketing situations, direct sale is not very efficient. In marketing many types of consumer goods, direct sale from the producer to the consumer is clearly impractical. The distribution of potatoes is a good example of this. Potatoes are raised by thousands of farmers dispersed throughout the country but generally located at a distance from the major markets. Potatoes are consumed by most Americans, the majority of whom are located in urban areas. These consumers normally buy potatoes frequently and in small quantities—at maximum a few weeks' supply in each purchase. To sell direct to consumers, farmers would have to assume total responsibility for storing, transporting, grading, and selling without the aid of retailers and other middlemen. To do this job they would need market information and financing and would have to assume the total burden of marketing risks. Direct distribution of potatoes would be prohibitively expensive and, at the same time, would be highly inconvenient for many consumers who prefer to buy all their food needs together and at a time of their own choosing. Even with such products as soap and flour, produced mainly by a few large manufacturers, direct distribution is still impractical because people buy these products so frequently and in such small quantities that the amount of money realized from each sale would be insufficient to cover the costs of reaching the customer. Distribution channels for such products are necessarily long, and individual marketing functions must be performed several times as products move from producers to consumers. But at each stage in distribution, these functions are performed in specialized ways and, under these conditions, it is often true that shortening the distribution channel results in *increased* distribution costs and *reduced* marketing efficiency.

So we see that repetition of marketing functions by successive levels of middlemen does *not* necessarily imply marketing inefficiency. It probably costs less for a wholesaler's salesman selling the products of hundreds of manufacturers to call on a retailer than it does for the salesman of a single

manufacturer to make the same call. Eliminating the wholesaler and his salesmen would mean that the manufacturers would have to hire salesmen to call on the retailers. The manufacturers would probably soon discover that the costs of direct representation exceeded the costs of having a middleman perform the same functions.

According to an old marketing saying, "you can eliminate the middleman, but you cannot eliminate his functions." The marketing functions must still be performed. The question is not which functions will be performed, but rather which combination of marketing institutions will be able to perform them most efficiently. And ultimately, the most important step is the proper division of responsibility among the institutions performing the functions at the different levels of distribution.

### CONCLUSION

In this chapter, we have examined the functions which are performed in marketing goods and services. The emphasis has been on the marketing process and the functions performed during various phases of that process. Little has been said about the marketing of individual products or about the institutions engaged in marketing, and what has been said has been by way of illustrating the performance of specific marketing functions. This is as it should be. Marketing functions, products, and marketing institutions are all essential elements of marketing. But it is the marketing functions that determine which products move through what combinations of marketing institutions, and that is why we have emphasized marketing functions and not products or marketing institutions.

### QUESTIONS AND PROBLEMS

1. "Marketing is involved in all business functions." Can you justify this statement, or does it merely reflect the prejudices of a marketing man?
2. Some of the marketing functions, such as transportation, storage, marketing financing, and product planning, are rarely placed organizationally under the top marketing executive. Explain this.
3. Is a marketing expert more likely to be "right" in a disagreement with a production expert over product specifications or characteristics? How would you determine this?
4. Can you provide an answer to the argument that it is to the advantage of the individual producer to avoid standardization in his product and its parts so that the buyer is forced to return to him for repair and servicing?

5. It has been claimed that grading of agricultural products is essentially worthless because it is not possible to measure the really important product differences such as flavor and texture. Discuss.
6. Retailers often use the expression, "Goods well bought are already half sold." Would you assume from this that selling is probably a less important function than buying to the retailer?
7. Since advertising normally arouses consumer interest, but will rarely stimulate prospects to buying action, it should be allocated only a small share of the promotional budget. Comment.
8. Do you think it is likely that special promotional devices such as coupons and trading stamps have very little effect on total demand and, therefore, merely raise prices to the consumer?
9. Packaging, the silent salesman, is an important factor in the sale of most food products. Why do you suppose it has been of such little importance in the sale of hardware products?
10. Maximum efficiency is achieved by evaluating total physical distribution costs instead of the separate costs of transportation and storage. Will this explain why it might be more economical for a shipper to use high-cost air freight instead of rail?
11. Give some reasons why a company may, under different conditions, use different kinds of transportation to ship the same merchandise.
12. Consumer credit is an extremely important factor in the sale of many hard goods. Explain, then, why the responsibility for the management of consumer credit is rarely given to the executive responsible for selling.
13. Through product differentiation, a producer may succeed in decreasing the risk of a change in the demand for his product because of over-supply in the industry. But, at the same time, will he increase certain other risks through this policy?
14. Market information gathered by formally-organized research procedures tends to be more objective and, hence, more valuable than information obtained from informal sources. Do you agree with this statement? Explain.
15. It seems pretty clear that the more marketing functions a consumer can perform for himself, the more efficiently will he obtain the goods he needs. Do you agree? Explain.

# INSTITUTIONS

AND

# CHANNELS I

# 4

In this and the following chapter, we will concern ourselves with distribution channels and with the institutions which perform the marketing functions that bring products into contact with markets and effect transfers of ownership. A channel of distribution may be defined as a path traced in the direct or indirect transfer of the title to a product as it moves from a producer to ultimate consumers or industrial users.<sup>1</sup> Every channel of distribu-

<sup>1</sup> The American Marketing Association has had a Definitions Committee since 1931, but the concept "channel of distribution" was left undefined until 1960. The definition used above is in accord with normal business usage and is widely accepted among marketing



tion contains one or more of these "transfer points," at each of which there is always either an institution or a final buyer of the product. In the process of marketing, legal title to the product always changes hands at least once. (This bare minimum is reached in situations where producers deal directly with consumers or industrial users and there are no intervening middlemen.) Generally, legal title to the product passes from the producer to and through a series of middlemen before the consumer or industrial user finally takes possession. Transfer of title may be direct, as when the producer sells the product outright to a wholesaler or retailer, or it may be indirect, as when an agent middleman does not take title but simply negotiates its transfer to another middleman. From the standpoint of the producer, such a network of institutions used for reaching a market is known as a channel of distribution.

Our plan of presentation is to consider the individual classes of middlemen before we examine the different types of channels of distribution. This does not mean that we believe that middlemen are any more or less important than the distribution channels in which they serve as transfer points. It *does* mean, however, that we think it logical to examine the building blocks, that is the institutions, before we look at the different ways they may be put together in order to constitute a channel of distribution.

#### SOME NECESSARY DEFINITIONS

Before examining the specific types of wholesalers and retailers and their operating characteristics, we should provide formal definitions for the following terms: middleman, merchant, agent, retailer, wholesaler, retailing, and wholesaling. These words form part of virtually everyone's everyday vocabulary, but the meanings ordinarily attached do not always agree with those assigned by marketing analysts and executives. Most of these terms, when used in a marketing context, carry far more precise and restricted meanings than they do in common usage.<sup>2</sup>

#### *Middleman*

Middlemen specialize in performing operations or rendering services which are directly involved in the purchase and sale of goods in the process of

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educators. The chief reason the writers have chosen not to use the A.M.A. definition is that it does not take into account the significant role played by the transfer of title in tracing distribution channels. The A.M.A. definition considers a channel of distribution as "the structure of intra-company organization units and extra-company agents and dealers, wholesale and retail, through which a commodity, product, or service is marketed." See: Definitions Committee, *Marketing Definitions* (Chicago: American Marketing Association, 1960), p. 10.

<sup>2</sup> Unless noted otherwise, the definitions in this section and the remainder of the chapter are those compiled by the Committee on Definitions of the American Marketing Association. See: Definitions Committee, *Marketing Definitions* (Chicago: American Marketing Association, 1960).

their flow from producer to consumer. As the name "middleman" would indicate, such business concerns are situated in the channel of distribution at some point between the producer and the consumer. Producers consider middlemen extensions of their own sales and marketing organizations, because if there were no middlemen, their own sales organization would have to carry on all of the negotiations leading up to final purchases by consumers. Consumers and industrial users consider middlemen direct sources of goods and points of contact with producers.

### *Merchants and Agents*

All middlemen fall into two broad classifications: merchants and agents. A merchant middleman takes title to (that is, buys) and resells merchandise. An agent middleman *negotiates* purchases or sales or both, *but does not take title to the goods in which he deals*. Thus, the chief distinguishing characteristic is whether the middleman takes title to the goods he handles. If he takes title, he is a merchant. If he does not, he is an agent. Also, the merchant always both buys and resells; whereas the agent *may* specialize in negotiating either buying or selling transactions.

### *Retailer and Wholesaler*

Middlemen may also be separated into two other major categories—retailers and wholesalers. The principal base for distinguishing retailers and wholesalers relates to whether the business sells in significant amounts to ultimate consumers. If it does, the business is classed as a retailer. If it does not, it is classed as a wholesaler.

A retailer is a merchant, or occasionally an agent, whose main business is selling directly to ultimate consumers. He is distinguished by the nature of his sales rather than by the way he acquires the goods in which he deals. Although he usually sells in small lots, this condition is not essential for a business to be classified as a retailer. The dealer who sells the furniture and floor coverings for the initial outfitting of a large home, for instance, may make a sale of several thousand dollars, but it is still a retail sale, if the buyer (that is, the homeowner) is an ultimate consumer.

Wholesalers buy and resell merchandise to retailers and other merchants and to industrial, institutional, and commercial users, but do not sell in significant amounts to ultimate consumers. Notice that this definition does not state that the wholesaler must deal in large-size lots nor does it require that he habitually make sales for purposes of resale. Most wholesalers *do* sell in large lots, but there are many who do not. Similarly, most wholesalers sell for purposes of resale, but there are many who sell directly to industrial users. So, the one essential distinguishing feature of the wholesaler is that he must be a middleman who usually does not sell to ultimate consumers.

### ***Retailing and Wholesaling***

Retailing consists of the activities involved in selling directly to the ultimate consumer. It makes no difference who does the selling, but to be classified as retailing, selling activities must be *direct* to the ultimate consumer. Retailers, of course, are engaged in retailing, *but so is any other institution that sells directly to ultimate consumers*. Manufacturers engage in retailing when they make direct-to-consumer sales through their own stores, by house-to-house canvass, or by mail order. Even a wholesaler engages in retailing when he sells directly to an ultimate consumer, although his main business may still be wholesaling. *If the buyer in a transaction is an ultimate consumer, the seller in the same transaction is engaged in retailing.*

Wholesaling consists of the activities involved in selling to buyers other than ultimate consumers.<sup>3</sup> These buyers may be wholesalers and retailers who buy to resell. They may be industrial users (manufacturers, mining concerns, firms in other extractive industries), institutional users (e.g., schools, prisons, and mental hospitals), commercial users (e.g., restaurants, hotels, and factory lunch rooms), government agencies, or farmers buying items they need to carry on their agricultural operations. Wholesaling may be carried on not only by wholesalers but by manufacturers, other producers, and other business units which make sales to buyers who are not ultimate consumers. *If the buyer in a transaction is buying for purposes of resale, or to further his business operations, the seller in that same transaction is engaged in wholesaling.* All sales not made to ultimate consumers may be properly described as wholesale sales.

### **PRODUCERS AS DISTRIBUTION CHANNEL COMPONENTS**

In any channel of distribution, the producer is the seller in the first of the sequence of marketing transactions which occur as the product moves toward its market. Such producers include enterprises engaged in manufacturing, in mining and the extractive industries, and in farming. Of these, manufacturers normally have the most power to influence the total sequence of transactions involving their products.

How much power a manufacturer has to influence this sequence of transactions depends on the opportunities he has for differentiating his product from those of competitors and his success in capitalizing on these opportunities. If his product can be differentiated and he can convince end-buyers (ultimate consumers or industrial users) that the differentiating features make it a better buy than competing items, the manufacturer

<sup>3</sup> The Committee on Definitions of the American Marketing Association does not provide a definition for "wholesaling."

has the power to gain a significant marketing advantage. An automobile manufacturer, for example, has many opportunities to differentiate his make of car both in appearance and as to its performance and operating characteristics. The manufacturer of common nails, by contrast, has little opportunity to make his product much different from those of his competitors. But capitalizing on a product differentiation opportunity requires more than simply convincing end-buyers of the superiority of the manufacturer's product. It must be possible for end-buyers to obtain the product from their suppliers at prices they are able and willing to pay. Different middlemen vary as to the "support" they are prepared and willing to give the manufacturer in terms of stocking, promoting, and actively selling the product. Different middlemen also vary as to what it "costs" the manufacturer to use them as components in his distribution channel, and this affects the price end-buyers ultimately have to pay. Balancing the need for support with the costs involved, the manufacturer tries to put together a distributive network which results in end-buyers having ready access to outlets handling the product at prices they consider reasonable. If the product is capable of much differentiation in ways that are important to end-buyers, the manufacturer can exercise considerable discretion in selecting members for his channel team—i.e., he has considerable power to control the sequence of transactions involving his product as it moves to market. If there is little opportunity for product differentiation, he has little power to control this sequence of transactions.

The manufacturer whose product is capable of being differentiated seeks to exercise some control over the order in which his product changes hands as it goes to market.<sup>4</sup> Usually, as we explained in the paragraph above, the manufacturer devotes his primary attention to the market—the end-buyers of his product. Starting with the market, the manufacturer attempts to detail the sequence of steps required to supply it with his product. Even before this, however, the manufacturer has tried to identify and evaluate end-buyers' needs and the strength of market demand and, in his research and product development work, has attempted to design a product which meets these needs. The sequence of steps required for moving the product to market, of course, may or may not call for the services of middlemen at one or more distribution levels. Even after he decides on this sequence—i.e., the channel of distribution—the manufacturer often devotes considerable effort to assure that the planned series of transactions takes place. Through his advertising and other promotional activities, for instance, he may work to build demand to the point where end-buyers insist that suppliers stock and sell the product. Or, as another example, the manufacturer may use his advertising to end-buyers as a vehicle for

<sup>4</sup> For a discussion of the relationship of product differentiation and the manufacturer's decisions on branding, see Chapter 16, pp. 431-436.

directing prospective customers to outlets where the product is on sale. In these and similar ways, the manufacturer seeks to assure that his distribution network will function according to plan.

Enterprises not engaged in manufacturing, such as mining concerns, firms in other extractive industries, and farmers, are much less able to exert significant influences over the total sequence of marketing transactions involving their products. These producers usually can do very little about differentiating their outputs to meet end-buyers' needs more closely, so opportunities for product differentiation are practically non-existent. Furthermore, producers engaged in non-manufacturing activities generally find it very difficult to stimulate the demand for their products. Demand for the mining company's output, for instance, is derived from the demand for products manufactured by its customers. The demand for aluminum, in other words, depends upon the demand for products fabricated by customers of aluminum mining companies—i.e., the demand for aluminum *per se* derives from the demand for such products, to mention a few, as aluminum beach chairs, pots and pans, golf carts, and aluminum siding and sash used in building construction. It might seem logical, then, for the mining company to direct its efforts toward stimulating the demand for its customers' products. Individual mining companies, however, are often too small to finance and mount promotional programs of the size that would be needed. A few large companies, as in the aluminum and steel industries, have had some success in stimulating the demand for products fabricated from aluminum and steel, but these companies are primarily engaged in manufacturing even though they operate their own mines.

The farmer's situation is similar to that of the mining company, for unless the farmer sells his crop through a cooperative, he is generally unable to support the extensive promotional program necessary to exert a significant influence on the demand for his product. Moreover, the demand for farm products also is usually derived from the demand for products of processors of agricultural commodities. When certain food processors in the early 1960's, for instance, began making oleomargarine out of "100% pure corn oil" and successfully promoted the health benefits of the new product to large numbers of consumers, increases in the demand for corn followed increases in the demand for corn oil margarine. Furthermore, unlike most manufacturers who find it relatively easy to drop or add products as demand conditions change, many farmers, such as orchardists, cattlemen, and grain farmers, are limited to a single crop by virtue of their land, equipment, and experience. Thus, they are unable to adjust the nature of their outputs to fit the changing needs and preferences of end-buyers.

As we have shown, different types of producers enjoy different degrees of power in controlling the flow of their product through channels of dis-

tribution to final markets. In general, manufacturers have the most power and are able (within certain limits which we will discuss later) to use channels containing the type and number of transfer points which, in their opinion, are most appropriate for product and market. Farmers and companies in the extractive industries cannot direct the flow of their products to market. But their products do eventually get to market, even though the marketing process tends to be more involved and roundabout than it is with most manufactured products. Distribution channels serving the extractive industries tend to develop in an unplanned way, the way a river "cuts" its own course.

#### *Individual Producers and Channel "Length"*

A producer's concern with channel management varies with the "length" of the distribution channel. "Length," as used here, has to do with the number of middlemen between the producer and the final buyers. A long distribution channel has a series of middlemen on different distribution levels. A short one has few intermediaries or none. In the shortest possible channel, with no middlemen at all, the producer does everything necessary to negotiate legal transfers of title to the product being marketed with the end-buyers. With the addition of one or more middlemen to the channel, negotiating responsibility is divided between the producer and middlemen on each level—i.e., the producer sells to the middlemen, and they, in turn, resell the product to other middlemen or final buyers.

To the extent that the producer is able to control the length of the distribution channel, he determines his own role in the series of negotiating transactions leading up to the sale to the ultimate consumer or industrial user. If the consumer goods manufacturer, for example, deals directly with ultimate consumers, he is serving as his own retailer. If he sells through retail middlemen and contacts them directly, he is acting as his own wholesaler.

#### *Producers' Cooperative Marketing Associations*

Hoping to improve the efficiency with which their produce is marketed, some groups of producers, chiefly in agriculture but sometimes in other extractive industries, have organized and operated producers' cooperatives marketing associations. These associations represent the collective effort of small producers who desire to gain more control over the distribution of their output in the hope of reducing distribution costs and exerting favorable influences on demand. Cooperative endeavors of this type have tended to put their member agricultural producers more on a par with manufacturers—at least so far as distribution channels are concerned.

The cooperative marketing association, with its great size and the specialized attention its management can give to marketing activities, can

usually make it possible to bypass one or more levels of middlemen in the more conventional distribution channels for agricultural products. Sometimes, only the assembler or broker of agricultural products is eliminated by the cooperative, but it often extends its marketing operations even to such activities as maintaining sales offices in important marketing areas, as is done by Sunkist Growers, Inc., a cooperative marketer of citrus fruits grown in California and Arizona. Most agricultural cooperative marketing associations are set up to handle the packing and grading of their members' crops, usually at a lower cost than they can manage doing it by themselves. Some, such as Sunkist Growers, have gone so far as to affix brands to their produce and conduct extensive promotional programs designed to build and maintain consumer recognition of the brand and to enlarge demand for it. Thus, the cooperative marketing association is often able to provide its members with enhanced power in controlling the flow of their product through channels of distribution to final markets.

One additional feature of the operations of many producers' cooperative marketing associations deserves mention. Many purchase such items as seed, fertilizers, tools and implements, and gasoline and oil for resale to their members, and a few also deal in various consumer goods. One, the Grange League Federation, or "G.L.F." as it is called by its members and customers, not only markets crops grown by its farmer-members but operates "stores" to supply members and others with items used on farms and such diverse goods as grass seed, lawn mowers, automobile tires, and food for wild birds. G.L.F. has members and stores throughout New York, New Jersey, and Pennsylvania.

### **MERCHANT WHOLESALERS**

There are two main ways of classifying merchant wholesalers. First, according to the range of merchandise they handle, they may be classified as (1) general merchandise wholesalers, (2) general-line wholesalers, and (3) specialty wholesalers. The second is to classify them by their method of operation as (1) service wholesalers and (2) limited-function wholesalers. These major classes of merchant wholesalers and the most significant of their subclasses are discussed below.

#### ***Classification by Range of Merchandise Handled***

**GENERAL MERCHANDISE WHOLESALERS.** A general merchandise wholesaler is a merchant wholesaler who carries a general assortment of goods in two or more distinct and unrelated merchandise lines. For instance, such a wholesaler may stock and sell dry goods, hardware, furniture, farm implements, electrical equipment, sporting goods, and household appliances. At one time, particularly during the heyday of the retail general store, staple groceries were the main stock-in-trade of general merchan-

dise wholesalers. But with the rise of cities, the growth of population, and the development of new types of retail institutions more appropriate to the times, the retail general store began to disappear from the scene, and with its gradual disappearance came a decline in the importance of general merchandise wholesalers till today there are comparatively few general merchandise wholesalers left.

**GENERAL-LINE WHOLESALERS.** The general-line wholesaler carries a broad assortment of goods within a single merchandise line, but he may also handle limited stocks of goods in closely related lines. Thus, a general-line grocery wholesaler usually carries not only a complete stock of canned fruits and vegetables, cereals, tea and coffee, and other "grocery store" items but also razor blades, soaps and detergents, toothpaste, school supplies and other items commonly sold in retail grocery stores. In consumer goods marketing, general-line wholesalers are important distributors of groceries, drugs, and hardware to independent retailers in these fields. In industrial goods marketing, general-line wholesalers are known as "industrial distributors" and supply such merchandise lines as electrical, plumbing, and heating goods to both large and small industrial users. The importance of the general-line wholesaler in consumer goods marketing has declined with the rise of corporate chains and other retail institutions which prefer to buy directly from producers. Similarly, there has been a trend among industrial users toward direct buying from producers, and this has had a repressing effect on the general-line wholesalers of industrial goods. But, since small-scale independent retailers continue in business and industrial users continue to need items in quantities too small to justify direct purchase, general-line wholesalers are likely to remain important marketing intermediaries in both consumer and industrial goods markets.

**SPECIALTY WHOLESALERS.** The specialty wholesaler carries only part of a merchandise line, but within his restricted range of offerings he has a very complete assortment. In the wholesale grocery trade, for instance, specialty wholesalers may specialize in canned foods; coffee, tea and spices; dairy products; frosted and frozen foods; and soft drinks. The specialty wholesaler represents an advanced step in what seems to be a universal trend among merchant wholesalers to restrict merchandise offerings.

Specialty wholesalers generally pride themselves on the strong promotional support they provide for the restricted number of manufacturers' brands they handle. They can provide this strong support because they concentrate on relatively few items of merchandise. It is possible for the



specialty grocery wholesaler's salesmen, for instance, in the routine performance of their duties, to "push" every item handled on every sales call and to perform such promotional activities on behalf of manufacturers' brands as erecting special displays, handling in-store product demonstrations, and arranging for the distribution of samples. Salesmen working for general-line grocery wholesalers, by contrast, find it impossible to give special "push" to more than a handful of the many thousands of different items in stock; the great breadth of this stock also makes it difficult for them to perform very much in the way of promotional activities on behalf of any one manufacturer's brand. However, the narrowness of the specialty wholesaler's merchandise offering together with the necessity for providing strong promotional support for all items handled causes him to concentrate on areas where there are large numbers of retail outlets. Selling only a few items and strongly promoting each one, he can make economical use of salesmen only in areas where there are many retailers to call on and relatively little travel time is required to get from one stop to the next. The specialty wholesaler's salesmen usually make very frequent calls on retailers but, as this makes it possible for retailers to carry smaller stocks, the average size of retailers' orders is small. The operating scheme of combining high call frequency and low average order size restricts the opportunity for specialty wholesaling to areas where retail outlets are close together and numerous—such areas, for example, as those in the heavily industrialized and thickly populated parts of New England, the Middle Atlantic states, the Midwest, and the Pacific Coast. In certain other areas (such as are found in many Rocky Mountain states and rural sections of the South), the population is sparse, cities and towns are far apart, and the resulting pattern is one where retail outlets are widely scattered and few in number; consequently, because these conditions do not lend themselves to this type of operation, there are relatively few specialty wholesalers in such areas.

#### *Classification by Method of Operation*

Merchant wholesalers generally perform many functions for their customers. Those who perform all or most of the functions and services normally expected in the wholesale trade, are known as *service wholesalers*. (These functions are: product planning, buying and assembling, storage, transportation, risk bearing, marketing financing, and market information.) General-line wholesalers perform these functions, and so also may be classed as service wholesalers. By contrast, some specialty wholesalers perform only a few of these services, other perform many. So, depending on the extent of his service, a specialty wholesaler may be classed either as a service wholesaler or as a limited-function wholesaler who performs only a few of the functions normally associated with wholesaling.

operations. The main types of limited-function wholesalers are discussed below:

**TRUCK WHOLESALERS.** Combining selling, delivery, and collection in one operation, truck wholesalers (also known as wagon jobbers) carry only a limited range of stock, though the selection within that range may be very complete. Thus, the nature of a truck wholesaler's merchandise offering also makes him a specialty wholesaler. Truck wholesalers call mainly on retailers, though some, such as those in the grocery trade, also number restaurants, hotels, and other food service establishments among their customers. Because the items they handle are often perishables or semi-perishables, truck wholesalers have to make very frequent calls on their customers, and indeed it is their ability to make fast and frequent deliveries that appeals to both their customers and the manufacturers they deal with.

**RACK JOBBERS.** The rack jobber is a wholesaling unit that markets specialized lines of merchandise to certain types of retail stores and provides certain special services as described below. The merchandising policies of most rack jobbers cause them also to be classed as specialty wholesalers. The original rack jobbers evolved after World War II to serve the special needs of supermarkets which, in increasing numbers, were adding non-food lines. Rack jobbers serving supermarkets and other grocery retailers usually specialize in one or both of two lines—toiletries and housewares. Managers of retail stores served by rack jobbers are relieved of the merchandising problems involved in handling what are for them "sundry items," and are free to concentrate their merchandising efforts on their major lines. The rack jobber may or may not furnish his own display racks but, basically, all that he requires of the retailer is an allocation of selling space which he stocks with a selection of items priced for immediate sale. Occasionally, the rack jobber may instead supply merchandise on consignment: that is, the jobber retains legal title to the merchandise up to the time the retailer sells it, the retailer paying only for the goods he sells and retaining a portion of the profit for himself. Through aggressive merchandising and efficient use of displays, rack jobbers have built up a large volume of non-food sales in grocery stores. Manufacturers of non-food lines find that rack jobbers provide an effective means for achieving low cost distribution through retail food stores.

**CASH-AND-CARRY WHOLESALERS.** Cash-and-carry wholesalers pursue at the wholesale level the same sort of service policy that has been successful in certain types of retail operations. Whereas service wholesalers send their salesmen to retailers to solicit orders, later deliver these orders, and

grant credit to retailers allowing them to pay at later dates, cash-and-carry wholesalers require retailers to come to the wholesale warehouse, "pick" their own orders, pay cash for what they buy, and carry away their own purchases. By restricting the services he will perform and lowering his operating costs, the cash-and-carry wholesaler can price his goods lower than can service wholesalers. Price, then, is what attracts retailers to the cash-and-carry wholesaler. But, because retailers must perform additional services for themselves, they often find that by the time the order gets to the store, its cost is every bit as high as if it were purchased from a service wholesaler. However, cash-and-carry operations do provide an economical means for wholesalers to use in reaching many small retailers who customarily buy in lots too small to justify the wholesaler's sending salesmen, providing delivery, and extending credit.

**DROP-SHIPMENT WHOLESALERS.** The drop-shipment wholesaler is a limited-function wholesaler who does not handle the goods he sells, but leaves the storage and transportation functions to the manufacturers whom he represents. When goods are ordered, the manufacturer ships them directly to the retailer, but bills the drop shipper at factory prices. Subsequently, the drop shipper collects from the retailer. This system of distribution makes possible reductions in the costs of transportation and storage. It eliminates the necessity for double hauling (i.e., from the factory to the wholesaler and then on to the retailer) and no costs are incurred for handling the goods in the wholesaler's warehouse. However, customers ordering through drop shippers often order in comparatively small lot sizes and, because freight rates are higher for small lots than for large lots, some of the savings from eliminating double hauling are offset by higher shipping costs. The retailer, to make economical use of drop shipments, must both order in larger than normal quantities and adjust his operations to allow for longer periods during which the goods are in transit. These adjustments are necessary since most retailers are separated by greater distances from the manufacturers' plants than they are from the relatively nearby wholesalers who serve as alternate supply points. Finally, the need for ordering in larger than normal quantities requires that the retailer invest additional funds in his inventory. Despite these unattractive features, however, retailers often find that the savings in cost are sufficient to justify drop shipments. This is especially true with standard, fast-selling items—ones which sell regardless of season and where the retailer bears little risk that he will be unable to resell the merchandise.

Drop-shipment wholesalers are also much used in industrial marketing. They are important distributors of such products as sand, clay, coal, and lumber where transportation costs are high relative to the value of the products and where, accordingly, any interruption of deliveries causing

breaks in production may lead to significant cost increases.<sup>5</sup> Industrial users consume these items in such large quantities and with such great regularity that it pays them to have several shipments in transit at any one time, each spaced to arrive before it is needed and always allowing some margin of safety for late arriving shipments. Thus, the industrial user manages to "work around" the long period during which drop shipments are in transit. Furthermore, these are commodities which the customers normally buy in lots which are large enough to gain freight rates as low as any a wholesale middleman might secure.

**MAIL-ORDER WHOLESALERS.** Mail-order wholesalers are limited-function wholesalers who sell entirely by mail. The mail-order wholesaler substitutes mail-order catalogs and order forms for a sales force, and passes on to retailers some of his savings in the form of lower prices. This limited-function wholesaler is mainly active in wholesaling such staple consumer goods as hardware and dry goods. With modern improvements in transportation and communication, there has been a sharp decline in the importance of mail-order wholesalers. The basic weakness of this type of operation is that it fails to provide a really adequate substitute for the strong promotional push salesmen can give. Moreover, its success rests on the willingness of retailers to take the initiative in placing orders, something that cannot always be counted on—especially when competitors' salesmen call on retailers in person.

#### **AGENT MIDDLEMEN**

Agent middlemen, most of whom are active in wholesaling rather than in retailing, assist in negotiating sales or purchases or both on behalf of their principals who may be buyers or sellers or both. Usually, the agent does not represent both buyer and seller in the same transaction and he is ordinarily paid by commission or fee. Although agent wholesalers as a group are active in many lines of trade, individual agents customarily concentrate on single commodities such as foods, grain, copper, steel, machinery, or textile items. The main types of agent wholesalers are brokers, commission houses, manufacturers' agents, selling agents, and resident buyers. These are discussed below.

#### **Brokers**

A broker is an agent who represents either buyer or seller in negotiating purchases or sales without physically handling the goods involved. The broker is more often the agent of the owner of goods seeking a buyer than the agent of a buyer searching for a source of supply. Each broker tends

to specialize in arranging transactions for a limited number of commodities or products and, as a result, he should be well informed concerning conditions in these particular markets.

Acting strictly as an intermediary, the broker has limited powers as to prices and terms of sale, and he possesses little or no authority to bargain on behalf of his principal. His main service is to bring buyer and seller together. Representing either the seller or the buyer (but not usually both in the same transaction) the broker relays the buyer's offer to the seller and the seller's counter-offer to the buyer and continues this process until the terms are satisfactory to both parties at which time the exchange takes place. He never has direct physical control over the goods, but sells by description or sample. Whenever he arranges a sale, the seller ships the goods directly to the buyer. The broker receives his commission from the principal who sought his services.

Brokers are most used by producers who sell their products at infrequent intervals and find it uneconomical to establish standing sales forces of their own or even to establish long-term relationships with other types of agent wholesalers. Although an individual producer may use the same broker year after year, each transaction is considered completely apart from every other. There is no obligation, on the part of either the broker or the seller, to maintain this relationship in future transactions. Small canners, whose production volumes are too small to justify their developing and promoting brands of their own, and whose entire output may be produced in a period of two or three months, often rely on brokers to dispose of their packs. Similarly, farmers harvesting one major crop a year often find it economical to use brokers.

Sometimes, brokers are also used by larger companies who want to extend the distribution of their products. In such instances, brokers serve as the key middlemen in arranging initial distribution of the product among other types of middlemen. Thus, a broker may be instrumental in opening up a new market for the producer or in gaining access to outlets previously not stocking the product.

#### *Commission Houses*

The commission house is an agent which usually exercises physical control over and negotiates the sale of the goods it handles. The commission house usually enjoys broader powers as to prices, methods, and terms of sale than the broker does, although it must also obey instructions issued by the principal. Generally, it arranges delivery, extends necessary credit, collects, deducts its fees, and remits the balance to the principal. Thus, except for the fact that it does not take title, the commission house performs functions very similar to those of service merchant wholesalers, more so in fact than any other agent wholesaler.

Most commission houses are concerned with the distribution of fresh fruit and produce. The relationship of the commission house and its principal generally covers a harvest and marketing season. The truck farmer, for instance, signs a seasonal agreement with a commission house situated in a market center and ships the crop as it is harvested. The commission house is authorized to sell each shipment on arrival at the best price obtainable without checking back with the seller. Although legal title to the goods never passes to the house, it sells in its own name, bills buyers, extends credit, makes collections, deducts its fees, and sends the balance to the truck farmer. Although the farmer might prefer to hold his produce off the market at times and bargain for higher prices, the factor of perishability makes any delays in selling extremely costly. The operation of the commission house is especially geared for rapid sale of perishable commodities, and this is the chief reason why the commission house continues to be important in agricultural marketing.

#### *Manufacturers' Agents*

Four main features usually characterize the operations of the manufacturer's agent: (1) he has an extended contractual relationship with his principal; (2) he handles sales for his principal within an exclusive territory; (3) he handles non-competing but related lines of goods; (4) he possesses limited authority with regard to prices and terms of sales. Some manufacturers' agents have physical control over an inventory, but most do not. Ordinarily the manufacturer's agent arranges for shipments to be sent directly from the factory to the buyer. Because his principal service is selling, the manufacturer's agent maintains a sales staff large enough to provide adequate coverage of his market area. The manufacturer's agent sells at prices, or within a price range, stipulated by his principal, and receives a percentage commission based on sales.

Manufacturers' agents are generally used when a manufacturer finds it uneconomical to use his own salesmen or when he is financially unable to maintain his own sales force. Some manufacturers, for instance, find that certain market areas simply do not provide enough business to justify their assigning salesmen to them. Yet, manufacturers' agents, each representing several principals, may be able to operate profitably in the same areas. Thus, it is not at all unusual for manufacturers to use their own salesmen in areas where there are large concentrations of potential business and to use manufacturers' agents elsewhere. Other manufacturers use agents to open up new market areas, and replace them with their own salesmen as the volume of business grows. Still other manufacturers, particularly those with narrow product lines and those that are very small, use a network of manufacturers' agents in order to avoid altogether the problems and expenses of maintaining their own sales forces.

Manufacturers' agents are most important in the marketing of industrial goods and such "durable" consumer goods as furniture and hardware items. In industrial goods marketing, they usually use salesmen who have considerable technical competence and contact industrial users directly. In marketing consumer durables they generally call on and sell to retailers. Many furniture manufacturers rely on manufacturers' agents to sell their entire output. In a good many cases the manufacturer's agent can, because of his intimate contact with the market, offer advice to the manufacturer on a wide variety of matters including styling, design, and pricing.

### ***Selling Agents***

The selling agent operates on an extended contractual basis, negotiates all sales of a specified line of merchandise or the entire output of his principal, and usually has full authority with regard to prices, terms, and other conditions of sale. Thus, he differs from the manufacturer's agent in that he ordinarily is not confined to operating within a given market area, has much more authority to set prices and terms of sale, and is the sole selling agent for the lines he represents.

Some selling agents render financial aid to their principals. This practice traces to the historical fact that early selling agents were usually much stronger financially than the principals they represented. Many textile mills, for instance, were originally started with the financial backing of selling agents, who saw this as a way to increase their own business volumes and, hence, their commissions. Today, selling agents rarely provide their principals with investment capital, but many help their principals in financing current operations. Because many modern-day selling agents continue to have higher credit ratings than their principals, it is fairly common for them to endorse their principal's short-term notes at banks and other lending institutions. Occasionally, too, a selling agent assists his principal financially either by making direct loans on accounts receivable or by "guaranteeing" these accounts so that a lender will advance needed funds to the principal. There has, however, been a trend away from this type of financing service by selling agents. This trend has accelerated with the growth of financial institutions known as *factors*, who specialize in "discounting accounts receivable"—that is, in making short-term loans with accounts receivable as the collateral.

The manufacturer who uses a selling agent, in effect, shifts most of the marketing to an outside organization. This frees the manufacturer to concentrate on production and other problems in non-marketing areas. In addition, as the selling agent is in close contact with buyers, he often is able to guide the manufacturer on styling, design, and pricing. Fairly often, he assists his principal with or takes over sales promotion and advertising. Sometimes, the selling agent, as is true of some in the textile

and apparel trades, even specifies the features that his principal should build into the product and how much he should manufacture. Furthermore, since the selling agent works for a straight commission, the principal's selling costs vary proportionately with sales made and no fixed selling costs are incurred. Thus, for all these reasons, it is not surprising that small manufacturers with neither the managerial talent nor the financial strength to market their own products use selling agents.

The manufacturer using a selling agent, however, should realize that he is "placing all his marketing eggs in one basket." Since the selling agent is the manufacturer's only contact with the market, the bulk of the bargaining power rests with the agent and not the manufacturer. Recognizing this, selling agents may be tempted to resort to price-cutting instead of exerting reasonable amounts of selling effort to sell the manufacturer's output. In such situations, the manufacturer, cut off from the buyers by the selling agent and having dealt with them only through this intermediary, is really "over a barrel." If he is weak financially and needs loans which cannot be obtained without his selling agent's help, he may not even be able to break with the selling agent in order to obtain another. The moral is clear: if a manufacturer is going to use a selling agent, his first choice should be a good one.

#### *Resident Buyers*

A resident buyer differs from most other agent middlemen in that he represents buyers only. Specializing in buying for retailers, he receives his compensation on a fee or commission basis. The resident buyer operates most often in lines of trades such as furniture and apparel where there are well-defined "market centers" to which retailers ordinarily travel in order to make their selections. Resident buyers maintain their offices in such market centers and, whenever retailers are unable to make the trip to market in person, serve as retailers' contacts with the sources of supply.

Resident buyers are completely independent of their principals. They should not be confused with the resident buying offices which are owned by out-of-town stores and are maintained in such market centers as New York. Nor should they be confused with the central buying offices maintained by chain store organizations. The resident buyer is purely and simply an independent agent specializing in buying for principals who are retailers.

#### *Auction Companies*

As indicated by its name, this agent uses the auction method of catalogs and competitive bidding by prospective buyers in order to sell products owned by its principals. Auction companies are particularly important in selling products of varying quality and products which cannot be efficiently graded—situations frequent in agricultural marketing. In the fresh



fruit and vegetable trade, auction companies are located in central markets, that is in cities which are important distributing points for such items. In the marketing of livestock and such agricultural crops as leaf tobacco, auction companies are located in principal producing areas and at shipping points. An auction company has physical control over the lots consigned to it, arranges for their display, conducts the auction, makes collections from the buyers, and remits the proceeds to the principals, less commissions.

#### **Other Agents**

Other types of agent middlemen have evolved to serve many special needs. It appears that whenever a large enough group of buyers or sellers needs some special marketing service, there are always enterprising individuals who will set up in business to provide that service. For instance, there are export and import agents operating in leading port cities who serve the needs of principals seeking foreign markets or overseas sources of supply. And there are purchasing agents, which are independent businesses, specializing in locating sources of supply for buyers of industrial goods. But the basic function of all agents is the same: they all help to bring buyers and sellers together and receive fees or commissions in return for their efforts.

#### **CONCLUSION**

Producers, wholesalers, and agent middlemen constitute the building blocks for channels of distribution to industrial users. Thus, it would be possible to discuss channels of distribution for industrial goods at this point. However, the problems of producers in establishing channels of distribution for their products are essentially the same for industrial and consumer goods, so it is logical to discuss channels of distribution for all products at the same time. Since retailers, which are essential building blocks in the consumer goods channels of distribution, are not described until Chapter 5, discussion of channels of distribution is located at the end of that chapter.

#### **QUESTIONS AND PROBLEMS**

1. What is the value of trying to differentiate between wholesalers and retailers when a great many institutions are carrying on both wholesaling and retailing activities? Has this distinction become artificial?
2. Producers who can differentiate their products have greater control over the channel through which their products are sold, but is there any real advantage in such control? Would not the traditional channel ordinarily be the best? Discuss.

3. Would you think that the greatest strength of a producers' cooperative lies in the economies of size or in its greater ability to differentiate its products? Explain.
4. General merchandise wholesalers have, to a large extent, faded from the American scene, but general-line wholesalers have retained a fairly important role. Why do you suppose this has happened?
5. Shouldn't it be to the advantage of a retailer to deal only with a very limited number of general-line wholesalers instead of a much larger number of specialty wholesalers? If so, how can you explain the greater growth of specialty wholesalers?
6. Limited-service retailers have captured an increasingly important share of the market in recent years. Why, then, haven't limited-service wholesalers managed to do the same thing at the wholesale level?
7. Would it be proper to say that the primary appeal of the truck wholesaler is that he allows the retailer to reduce his merchandise turnover? Explain.
8. Wouldn't it seem logical that, if a rack jobber can sell "sundry items" at a profit in food stores, the management of large food chains should be able to do the same job as profitably? Why, then, do many of these chains use rack jobbers?
9. Would you be likely to find cash-and-carry wholesalers in the same kinds of cities and the same general locations as service wholesalers? Explain.
10. Is there likely to be any real advantage in using drop shipment wholesalers, if the retailer finds it necessary to buy in larger than normal quantities so as to keep transportation costs in line?
11. Would it be a fair assessment to say that the primary cause for the lack of success of mail-order wholesalers is laziness on the part of retail buyers? Comment.
12. The choice as to whether a farmer is more likely to use a broker or a commission house to sell his product will depend primarily on the length of his harvest season and the perishability of his product. Do you agree?
13. Would you agree that a manufacturer should normally look on the manufacturer's agent as a temporary distributor, to be used only until he can be replaced by the company's own salesmen?
14. Purchasing through an auction company is an inefficient method of procurement. Please comment on this statement.

I N S T I T U T I O N S

A N D

C H A N N E L S I I

# 5

Since retailing, as defined in Chapter 4, consists of the activities involved in selling directly to the ultimate consumer, this activity is inherent in all consumer goods distribution channels. The producer occasionally performs the retailing activity himself, but he generally relies on an independent retail institution to sell his products to the consumer. For this reason, retailers are of utmost importance in the distribution of consumer goods. They are the most numerous of all marketing institutions and wherever there is more than a handful of people, there are retailers.

**RETAILERS**

Individual retailers adjust their operations to the market when they determine the merchandise they will handle, their scale of operations, pricing policy, locations, and selling methods, and by the choices they make on other operating policies and practices. Because of the many choices open to retailers on such matters, there is tremendous variety among retail institutions. Retail institutions range all the way from the corner grocer to the multi-billion dollar corporate chain. But regardless of the specific class of retail institution, the basic economic purpose remains the same: buying and assembling the products of manufacturers and other producers and reselling them to ultimate consumers. Operating characteristics of the main classes of retail institutions are set forth and analyzed in the following sections. The only significance attached to the order of treatment is that it is generally chronological—the oldest are treated first and the more recent developments later.

*House-to-House Selling*

Modern house-to-house salesmen are descended from the "Yankee peddlers" who, on foot, on horseback, and then in wagons, traveled from farm to farm and settlement to settlement selling various manufactured articles to pioneers and frontiersmen. Today's house-to-house salesman, however, usually restricts his offerings to a small number of articles within a single merchandise line. He may specialize in encyclopedias, lawn and garden stock, vacuum cleaners, china, cosmetics, and household cleaning materials. Although many house-to-house salesmen are "freelance" independent small businessmen, most of them work for the many large manufacturing companies using this retailing method. Among these large concerns are such well-known organizations as Avon Products (toilet articles), The Fuller Brush Company (household articles), Real Silk Hosiery Mills (hosiery, dresses and lingerie), and Electrolux Corporation (vacuum cleaners). The sales people employed by the larger house-to-house organizations are almost equally divided among men and women, and more than half work at their jobs on a part-time basis. Thus, it is not unusual for a direct selling company to have from 5,000 to 10,000 sales people, nearly all working on a commission basis. Avon Products is said to have over 100,000 people, mostly women, selling part-time.<sup>1</sup>

Although house-to-house selling eliminates the expenses of retail store operation, it is by no means a low-cost method of retailing. It requires travel and personal contact, and the substantial costs involved in recruit-

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<sup>1</sup> A. Haring, "How Can Door-to-Door Selling Perk Up Your Profit Picture?" *Sales Management*, October 21, 1960, p. 106.

ing, maintaining, and managing sales staffs large enough to transact a profitable volume of sales. These cost conditions have had an effect on the operating methods of direct selling companies. Many handle either fairly high-priced items or articles that are sold in assortments, the purpose in both cases being that of building up the average order size. Some, such as The Fuller Brush Company, strive to make more effective use of salesmen's time by making steady customers. Others, such as Stanley Home Products, have been successful in using "party plan selling," in which a group of potential buyers are brought together in one of their homes for a product demonstration. Several orders will often result at one time. The commissions paid to house-to-house sales people usually range from 25 to 40 per cent of the retail price of each product being offered for sale.

The total costs of house-to-house selling run to approximately 60 per cent of sales. This estimate includes not only salesmen's commissions, but the costs of supervision and administration, clerical work, shipping, credit, and promotion and advertising. This may appear high, and it is for retailing. But companies using house-to-house selling normally do not have to allow for wholesalers' and retailers' margins, nor do they generally have large amounts of fixed selling and administrative expense. Whether house-to-house selling is an expensive distribution method depends on what the manufacturer's alternatives are. If, in their consideration, they include the use of wholesalers and retailers and the maintenance of a full-time permanent staff of salaried salesmen, it may well be that house-to-house selling is economical by comparison.

There are times when house-to-house selling is the solution to a manufacturer's marketing problems. Sometimes, this is the only way a radically different new product can be introduced, particularly by a company with limited finances. It is said, for example, that the inventor and original manufacturer of one of the finest can-openers had tried unsuccessfully to secure distribution through wholesalers and conventional retailers. The threat of imminent bankruptcy caused him to try door-to-door selling, which proved successful. A few years later, he had no difficulty in securing distribution through conventional retailers.<sup>2</sup> Some products seem to sell more easily when demonstrated in the home, and this seems to be the key to the success of house-to-house sellers of vacuum cleaners, sewing machines, and rug cleaners. Still other products, such as encyclopedias and Bibles, appear to be ones where most consumers will not initiate buying action by searching them out in retail stores, but which they will buy if approached in their homes.

<sup>2</sup> *"The Right of Free Men to Engage in Legitimate Business"* (New York: National Better Business Bureau, Inc., 1957).

*Independent Stores*

An independent store is generally defined as a retailing business unit controlled by its own individual ownership or management. Although there are both large and small independent stores, most large-scale, independently-owned stores are classified under such other headings as supermarkets, department stores, and discount houses. In our discussion, we will consider an independent store to be any individually-owned or managed retail business unit, small or large, which cannot be readily classified as a supermarket, department store, or discount house. We will use this working definition in an attempt to side-step the academic problem of distinguishing small-scale from large-scale retailers. How does one, after all, decide where "small" ends and "large" begins? The sales-volume yardstick is the one most used, but number of employees, square feet of floor space, and inventory dollar size have all been tried. One big difficulty with all these measures is that the dividing line must still be chosen arbitrarily, and furthermore, the idea of just what "large" means keeps changing. In the early 1940's a grocery store with \$250,000 in annual sales was considered rather large, but by the mid-1950's a store in that same range was considered small. Thus, the criteria for largeness are constantly being revised upwards. But since at any given time some retailers *are* smaller than others, we will, in the following discussion refer to independent retailers as being relatively "small" or "large."

The general store is one of the oldest types of independent retailers. It is a relatively small retailing business, not departmentalized, usually located in a rural community, and primarily engaged in selling a general assortment of merchandise of which the most important line is food. Its more important subsidiary lines are notions, apparel, farm supplies, and gasoline. These stores were important in farming and frontier sections until, in the 1920's, the spread of other types of retailing and widespread ownership of automobiles caused them to decline. Some general stores, though, still operate in sparsely-populated areas of the West and South.

Today, most small independent stores are concentrated in fields where it is "relatively easy to set up in business." This usually means that no great amount of capital is needed, or that easy financing is available. This probably is the main reason why there are so many small independent grocery retailers—a fairly small investment in inventory "turned over" rapidly results in a sales figure many times the value of the inventory. This same situation is found in gasoline retailing, and, in addition, many petroleum refiners offer generous financial assistance to individuals who want to open their own stations. Many small retailers, of course, are well-financed, but they are the exceptions.

Small independent retailers frequently meet strong competition from large retail chains, supermarkets, and department stores. The small independent usually buys his inventory from wholesalers or other middlemen, rather than directly from producers, so his merchandise costs tend to be higher than those of his large, direct-buying competitors. Thus, he must charge higher prices (to cover his costs) than his competitors. So, in most instances, the small independent must use something other than price appeal in his efforts to attract trade. The more successful ones usually find some way to differentiate their stores in the minds of their patrons. It may consist of nothing more than personalized service and the maintaining of friendly relations with customers. Or the independent may stay open longer hours than larger competitors and offer such extra services as credit and delivery. A convenient location, too, may be attractive to customers. As long as substantial numbers of ultimate consumers continue to consider such things important, small independent retail stores are likely to continue in operation.

Larger independent stores are most important in retail fields where corporate chains, department stores, and other integrated retail institutions either possess no operating advantages or are at a competitive disadvantage. In furniture retailing, for instance, the independent store buys most of its inventory either directly from manufacturers or through manufacturers' agents. These are the same sources from which the furniture chain and the department store's furniture department must buy. Whereas the chain may buy larger quantities than the independent, the resulting quantity discounts it gains are generally too small to permit it to use the "lower price" appeal effectively. Possibly of even greater significance is the fact that *most* furniture pieces are not at all standardized, either in appearance or construction. In a few large cities such as New York, several furniture outlets handle the same manufacturer's line, and in these cities, of course, consumers can shop around and compare prices. In most places, however, each furniture manufacturer tends to sell exclusively to a single store or to several but restricting each to some part of the merchandise line; therefore, it is virtually impossible for consumers to compare prices of the "same" piece from one store to another. This is what makes merchandise selection especially important in successful furniture retailing, and whereas the local independent can offer furniture that is "in tune" with the consumer preferences in its own locality, chain organizations, with their centralized buying procedures, find it hard to adjust their buying patterns to fit the unique preferences of local markets.

Some large independent stores are successful because their owners have specialized knowledge which enables them to "run rings-around" larger competitors. Examples abound in the retailing of such goods as oriental rugs, musical instruments, and sports equipment. Large numbers of con-

sumers hesitate to buy such items in the absence of what they consider professional advice. Chain stores and department stores sell these items, but they usually have to resort to employing less well-informed personnel.

Another group of large independent retailers has succeeded in building local reputations as "quality stores." Some handle large assortments of related merchandise, e.g., men's or ladies' apparel, and pride themselves in having the latest fashions. Others deal in lines, such as jewelry, where consumers consider the "store image" almost as important as merchandise quality. Independents often find it easier to build prestige reputations than do their chain store or department store competitors. In addition, many independent quality stores are old and well established; it is not easy for competitors to acquire quality reputations locally in the space of a few months or years.

In comparison to their competitors, successful independents, both large and small, possess significant advantages. Probably the most important is that they can more easily adapt their operations to fit the unique needs of the communities in which they do business. Furthermore, there is no question but that the owner-managers of a good many successful independent stores are more able and more aggressive than managers of competing chain stores and department managers of department stores. Nor should it be overlooked that large numbers of consumers tend to be loyal to locally-owned and operated stores and look askance at stores controlled from out of town.

#### *Mail-Order Houses*

A number of developments contributed to the founding and growth of mail-order houses. Montgomery Ward and Sears Roebuck, founded in 1872 and 1886 respectively, both owed much of their early success and rapid growth to the completion of the railroads and improvements in postal service, including the advent of rural free delivery. These developments in transportation and delivery coupled with the comparative isolation from retail centers of most of the rural population, set the stage for an enthusiastic reception for mail-order merchandising. General stores, formerly the chief source of supply for the farm population, found themselves hard-pressed to meet either the prices or the extensive merchandise offerings of the mail-order houses. Consumers in small towns also were attracted as customers of the mail-order houses, even though most such towns had stores which collectively offered nearly as wide a merchandise selection.

Both Montgomery Ward and Sears Roebuck confined themselves solely to mail-order operations until the 1920's. In 1921, Montgomery Ward opened its first retail store, and this was followed in 1925 by Sears Roe-



buck's first retail store. Their opening of retail stores was hastened by the spectacular growth in automobile ownership and by the great improvements in rural roads. These developments served to transform many rural consumers into small-town shoppers, and lessened the relative attractiveness of mail-order buying. Furthermore, the population of the country was shifting more and more from being primarily rural to being primarily urban. The managements of Ward's and Sears were alert to the marketing significance of these changes, hence their decisions to open retail outlets in urban centers. Today the bulk of the sales of both concerns comes from the sales of their retail stores, though mail-order still accounts for sizable proportions of their business. Indeed, the retail stores of both companies feature "catalog order desks," which solicit orders for delivery by their mail-order operations. In some locations, too, both Sears and Ward's maintain "catalog order stores" at which consumers are invited to place mail orders either in person or by telephone. Mail-order houses such as those of Ward's and Sears, offer wide assortments of articles within each of a large number of merchandise lines. Usually, such mail-order houses buy directly from the producer, often contracting for a large share or even all of the producer's output. Many small manufacturers are completely dependent on one or the other of the large mail-order houses for distributing all they produce. Most of the over 20,000 sources of supply for Sears, for instance, are small manufacturers. Indeed, the company is on record as stating that, "We prefer to work with smaller factories, who concentrate on production, and look to us for a substantial part of their distribution."<sup>3</sup> In the case of Sears, such small manufacturers have been the main suppliers of Sears' own brands—e.g., *Kenmore*, *Homart*, *Craftsman*, *Silvertone*, *J. C. Higgins*, and *Charmode*.

More limited selections of merchandise are also sold by the mail-order method. Small manufacturers often rely on this method to dispose of much or all of their output. Among the items "retailed directly" by such manufacturers are shirts, men's and women's apparel, toys, bird houses and feeders, and rugs. Some of these manufacturers distribute catalogs to consumers, but more often they use direct-mail promotional literature and small advertisements in magazines and newspapers. Mail-order retailing is an important distribution method, too, for many growers of trees, shrubs, plants, and seeds who generally distribute both fall and spring catalogs to homeowners throughout the country.

Mail-order retailing is the selling method used also by the many "of-the-month" clubs. These clubs typically provide their so-called members with the service of pre-selected merchandise, thus relieving members of the need for choosing their purchases from a large number of possible

<sup>3</sup> *The Buying Story*, reprinted from the 1956 *Report to Stockholders* (Chicago: Sears, Roebuck and Co., 1957), p. 6.

alternatives. *Book-of-the-Month Club*, for example, informs its members of monthly selections which must be *rejected* by members if they do not wish to receive them. Members not sending in rejections automatically receive monthly selections and are billed accordingly. Members of "of-the-month" clubs generally are required to accept a given number of selections during their first year of membership, after which they may, on their own initiative, write the club cancelling their memberships. Club members, therefore, are in the position of finding it easier to accept rather than reject selections and to continue rather than discontinue their memberships. Because of the features of their operating scheme, the clubs are often said to provide automatic distribution for products chosen as monthly selections. Most of the clubs are true middlemen, for they make their purchases from producers and resell them to consumers. The book clubs are the longest established in this field, but there are also similar organizations engaged in mail-order retailing of such items as food, fruit, toys, gifts, and foreign imports.

#### *Department Stores*

The department store appears to have been a European, rather than an American, retailing innovation. The Bon Marché and other Paris department stores came into existence and flourished during the period of the French Second Empire (1852-1871). Leading American retailers of the 1850's and 1860's regularly visited Paris and other European market centers on buying trips, and undoubtedly observed the operating methods of the Bon Marché and other European department stores.<sup>4</sup> The result was that the idea was transplanted to this country. Among the American firms which began operating as department stores during this period were R. H. Macy (New York), Jordan Marsh (Boston), Marshall Field (Chicago), Scruggs-Vandervoort-Barney (St. Louis), Meier & Frank (Portland, Ore.), City of Paris (San Francisco), Thalheimer Brothers (Richmond, Va.), and Rich's (Atlanta). Not all of these would have qualified as department stores at the times of their founding; most started out as other types of businesses and switched later to the department store type of operation. By the close of the 1870's, department stores were well-established in nearly every major city and many smaller cities and towns.

Formally defined, a department store is a large retailing business unit which handles a wide variety of shopping and specialty goods (including women's ready-to-wear and accessories, men's and boys' wear, piece goods, small wares, and home furnishings) and is organized into separate departments for purposes of promotion, service, and control. Thus, the two main features of the department store are a broad merchandise

<sup>4</sup> P. H. Nystrom, *Economics of Retailing* (New York: Ronald Press, 1932), p. 127.

offering and departmental organization. Responsibility for buying and selling is decentralized to individual departments, each carrying different lines of goods, and each under the control of a merchandising executive who is usually called a buyer or department manager. Buyers are relatively free to operate their departments as they see fit, as long as their operations produce profits considered adequate by the store's top-management. In addition to exercising general supervision over merchandising operations, the store's central administrative organization operates and maintains the physical facilities, provides such services as credit and delivery for the customers, and assists the merchandising departments with such functions as advertising and promotion.

Originally, department stores relied on the great breadth of their merchandise to attract customers. Gradually, however, some of the more aggressive stores, seeking to build their trade, broadened the range of services offered customers. Today, it is a rare department store that does not provide such customer services as charge accounts, installment plans, and home delivery. Some offer such exotic services as elaborate restaurants and tea rooms, nurseries to care for small children, and free instruction in arts and crafts. A few of these services are self-supporting, others are not. But even though many of these services do show an "accounting type" loss, they are maintained by the store because of their proven power to "pull in" customers.

By its very nature, the department store is a "horizontally integrated" retail institution. It brings together under one roof a range of merchandise offerings comparable to the combined offerings of many stores specializing in single or fewer merchandise lines. Although this "exposition-like" character is the source of much of the department store's drawing power, it is not without its disadvantages, particularly in purchasing. Some departments do enough business to justify direct-buying from sources of supply, but many do not. The small-volume departments, particularly in individually-owned stores, often are unable to buy in large enough lots to qualify for the quantity discounts obtainable from manufacturers and, hence, must frequently resort to buying through wholesalers and agents, which results in rather high merchandise costs.

Because of the disadvantages they encounter in purchasing, independently-owned department stores have begun to organize buying groups. Member stores of buying groups cooperatively own, maintain, and use the services of resident buying offices located in such main market centers as New York and Chicago. Through consolidation of the orders of member stores, the buying office is able to achieve considerable savings by placing orders for lots larger than any member could afford to buy individually. Furthermore, the combined bargaining power of the stores

often results in lower price quotations by suppliers. A secondary, though important, function of the resident buying office is to provide its member stores with current information on prices, availability of new items, and trends in fashion.

Many previously independent department stores have been absorbed into ownership groups. Most such department store ownership groups were put together originally by financiers rather than by merchandisers. They were not intended primarily to result in improved operating efficiency but rather in immediate profits for the organizers who, as financial middlemen, were most interested in profiting from the flotation of new issues of common stock. But, over time, central managements of the ownership groups lost their solely financial orientations and began to emphasize the improvement and standardization of operating policies and procedures. One early development was the centralized buying offices which enabled stores in the group to buy many standard stock items and some fashion goods at lower costs. Nevertheless, many types of merchandise are still bought by stores individually. Among these are high fashion items where speed of procurement and direct contact with the producer is important and the kind of articles which are needed to satisfy purely local demands. Top-managements of the department store ownership groups have also worked toward greater uniformity in non-merchandising activities, such as in the standardization of personnel policies and store operating systems and records.

Usually, each department store in an ownership group plans its merchandise offerings so as to cater to classes of trade in its own selling area. Because most of the inventory is composed of shopping and specialty goods, and because consumer preferences for such articles vary considerably from one area to another, most department stores, whether or not they belong to ownership groups, find it difficult to standardize the merchandise offerings of stores in different locations. Furthermore, stores in the same ownership group often attract different classes of trade in different cities. The uniqueness of the merchandise offering and the classes of trade catered to results in each store having a distinctive image. That is the main reason why most department store ownership groups continue to operate stores under the names they had when they were independently-owned. Allied Stores Corporation, for instance, operates, among others, Jordan Marsh in Boston, Titcher-Goettinger in Dallas, the Bon Marché in Seattle, Dey Brothers in Syracuse, and Anderson's in Boise. Federated Department Stores operates, among others, Filene's in Boston, Shillito's in Cincinnati, The Boston Store in Milwaukee, Bloomingdale's in New York, and Abraham & Straus in Brooklyn. Each of these stores has quite a distinct image in its own trading area.

### *Chain Store Systems*

Fundamentally, a chain store system is a group of retail stores of essentially the same type, centrally owned and with some degree of centralized control of operation. This definition is broad enough to include not only the well-known A. & P. and Woolworth "chains" but also Ward's and Sears' retail stores and the different department store ownership groups. So, basically, the distinguishing feature of a chain store system is that it owns and controls a group of stores. The department store ownership group is one type of chain store system, the retail stores of Montgomery Ward are another, and the F. W. Woolworth stores represent still another type. However, if only by virtue of long-established and customary usage, the term "chain store system" normally refers to a multi-unit retailing operation which cannot be categorized as a department store ownership group or the retail outlets affiliated with a mail-order house. This is the usage adopted not only in the following discussion, but throughout this book.

The strengths of the chain store system trace directly to the fact that it is horizontally-integrated (i.e., it operates multiple stores). With the addition of each new store, the system extends its "reach" to another group of prospective customers. Also, each store added means greater sales volume and, consequently, increased opportunity to effect economies through buying in larger-sized lots. It also means that the costs of central administration and of providing highly-specialized merchandising, buying, and promotional services can be spread over more stores. Thus, such costs are reduced for each store in the system. Furthermore, other economies are effected through standardization of store systems and procedures and the adoption of uniform personnel policies. These strengths, all due primarily to horizontal integration, are reflected in lower costs for the merchandise handled and in generally lower operating expenses than those incurred by the independent retailer.

The chains have in still other ways reduced their merchandising and operating expenses. Some savings were secured by eliminating such customer services as credit and delivery. Others were obtained by limiting the variety of merchandise available by stocking, for example, only three different brands of canned string beans in each of two sizes, rather than ten brands in four sizes. Still others were realized through application of the basic merchandising philosophy of the chain, which is to squeeze the maximum sales out of each dollar invested in inventory. In other words, the chain gears its operations so that its inventory is small relative to the size of its sales volume. One aspect of applying this philosophy relates to the chain's decisions on the composition of the inventory. It seeks to maximize the number of items which have a short shelf life (the fast sellers)

and tries to minimize those with a long shelf life (the slow movers). Another, and probably more important, aspect concerns the typical chain's approach to the problem of making sales. It attempts to build a large sales volume by underselling many of its competitors; this means, in effect, that the chain is satisfied with a comparatively low profit on each item sold. Successful application of this merchandising philosophy results in a large sales volume relative to the size of the inventory. And in addition to the fact that the typical chain is very careful about the make-up of its inventory, we can also say that it "works its inventory harder" than many competitors. Whereas the chain stresses large sales volume and low unit profits, many of its competitors are satisfied with small sales volumes and high unit profits.

Because the chain store system is a high-volume operation, it ordinarily gets its merchandise directly from producers or through their agents. Rarely does a chain system buy from merchant wholesalers, for the system is usually able to buy in even greater quantities than the wholesaler can, and with greater quantity discounts. So, by operating its own warehouses, the chain store system effectively becomes its own wholesaler. Thus, chain store systems can also be classed as vertically-integrated institutions, because they take over and perform for themselves functions which would otherwise be performed by separate wholesale institutions.

The weaknesses of the chain store system are derived from its horizontal integration and merchandising philosophy. Centralized decision-making often means that individual chain stores cannot react to changed local conditions as quickly as the more alert of their independent competitors. When individual chain units lag behind the independents in making new products and brands available, and they frequently do, centralized purchasing is usually at fault. Furthermore, in keeping with the large sales volume and low profit merchandising philosophy, the chain must economize on other costs and dispense with such services as charge accounts and delivery. In doing this, they effectively concede to competitors the patronage of consumers desiring these services. Moreover, because of its integrated nature, the chain has many stores and requires many managers—recruiting, training, and retaining them in the numbers needed are formidable tasks. Individual chains, of course, have found ways to deal with or minimize these inherent weaknesses; nevertheless, it is these weaknesses, together with the "impersonal and cold" character of most chains, that serve to offset many of the competitive advantages chains have over independents.

Chain store systems are important links in the distribution system for many types of convenience goods which, as you will recall, are goods that consumers generally want to buy frequently, immediately, and with minimum shopping effort. Both large and small manufacturers of grocery and

drug products, for instance, know that their brands cannot be made sufficiently available to large masses of consumers unless chain outlets stock them. Manufacturers of many items sold through variety stores find that if they are to achieve the sales volumes necessary for mass production, they must have chain store distribution. Holding out to producers of convenience goods the tempting prize of widespread and high-volume retail distribution at a relatively low selling cost, skilled chain store buying specialists drive hard bargains. They push for and usually obtain the lowest possible prices and the most advantageous promotional allowances, which are payments made by manufacturers to retailers in return for advertising and otherwise promoting products at the retail level. Normally, chains handling convenience goods expect most suppliers to promote their own products with heavy consumer advertising in order to minimize the "in-store" selling effort needed. In cases of products which do not lend themselves to such promotion, the chain often prefers to handle its own "store" brands, packed for it either under contract by outside manufacturers, or by "captive" (that is owned by the chain) canning or processing plants.

Chain store systems are also important retailers of shopping goods which, you remember, are items consumers select and buy only after doing some "shopping around." Chains are extremely active, for instance, in the retailing of men's and women's apparel, dry goods, and shoes. In contrast to many of their independent competitors in these lines, however, the shopping goods chains tend to concentrate on low-priced and fast-selling items. In other words, chains specializing in shopping goods seek items that resemble convenience goods as closely as possible. To obtain them, a chain often has to forego handling high-fashion merchandise in favor of more staple items. For this reason, too, along with their need for large sales volumes, shopping goods chains generally cater to consumers in the middle and lower income groups. Such chains commonly have manufacturers under contract to supply them with goods according to the chain's own specifications. The supplying manufacturers need not be especially large, but they must be large enough to assure the chain that they can produce enough to meet its requirements. In some instances, shopping goods chains are the retail arms of the manufacturers who own and control them. The Robert Hall chain, a retailer of men's and boys' clothing, is a division of United Merchants and Manufacturers, Inc. Similarly, the Thom McAn stores are operated by Melville Shoe Corporation. Other manufacturers, such as the shoe-manufacturing Endicott-Johnson Corporation, sell only a fraction of their output through their own retail chains and market the rest through other types of retailers. But even when chain store systems are controlled by manufacturers, there are needs for outside sources of supply. Thus, a manufacturer-controlled shoe chain, such as Endicott-

Johnson's own stores, retails not only shoes but such related items as hosiery and shoe polish bought from other sources.

### *Retail Cooperatives and Voluntary Groups*

With the expansion of chain store systems in the 1920's, especially in grocery and drug retailing, independent stores suffered serious patronage losses. Some independents thought they could safely ignore their new competitors; others believed that something had to be done to improve their waning competitive position. Particularly alarming to most independents was the fact that chain outlets were selling items at retail prices lower than the independents' own wholesale costs. The low chain prices were apparently living evidence that substantial savings in merchandise costs were possible if the wholesaler was eliminated from the distribution channel, and independent grocery and drug retailers began to devise new schemes for the reduction of their own wholesale costs.

Some independent retailers formed cooperative buying clubs. They hoped that the club could obtain lower merchandise costs, and thus enable its members to meet chain store prices. Most of these cooperative buying clubs were failures because, generally, they had no formal organization and their buying operations were sporadic. Many manufacturers refused to deal directly with them, often because of pressure applied by wholesalers. Furthermore, the independents who formed buying clubs too often failed to recognize that the low prices the chains were able to advertise were not solely the result of their buying advantage. They were actually traceable to policies the chains had adopted from the very first: these were the cash-and-carry system, the self-service store layout, and the advertising of "loss leaders." (A loss leader is an item priced under cost which serves as a device for drawing customers into the store.) Most independents provided credit and delivery services, operated full-service stores, and made little use of advertising. Unlike the chains, they hesitated to pass marketing functions on to consumers; consequently, they had to charge higher retail prices to cover the costs.

Gradually, groups of independents began to recognize the need for more formal organizations that would operate continuously rather than sporadically, and there evolved the retailer cooperative, an enterprise owned and controlled by retailer-stockholders who patronize it and share in any savings in proportion to their patronage. In contrast to the buying club, the retailer cooperative has a warehouse, carries inventory in stock, and employs a manager. Even more significant is the fact that it renders advice and assistance on such retail merchandising problems as store layout and location, store operation, record systems, and personnel policies. Often, too, the manager of a retail cooperative persuades members to adopt a uniform name for their stores and to engage in cooperative advertising,



thus reshaping the organization more in the image of a chain store system. However, most retailer cooperatives place more emphasis on group buying than on group promotion.<sup>5</sup> Experience indicates, nevertheless, that placing heavy emphasis on group promotion is an important key to the success of most retailer cooperatives. Only where retailer cooperatives have given really large emphasis to group promotion have their independent retailer-members become strong competitors of chain store outlets.

In other instances, it was a wholesaler who took the initiative in organizing independent retailers into a voluntary group. Each retailer affiliating with a voluntary group owns and operates his own store but is associated with the sponsoring wholesaler for buying and merchandising purposes. The retailer-members are expected to concentrate the bulk of their purchases with the sponsoring wholesaler. They are also required to operate their stores under the group name and to display uniform store signs with the purpose of maintaining some degree of identity among their stores and in their promotional efforts. The wholesaler, in turn, tries to supply the retailer-members with merchandise at the lowest possible prices. In addition, he prepares and places advertising in local media and provides advice and assistance on other problems. Whereas the early voluntary groups admitted any independent retailer of any size, the more recent trend has been to restrict membership only to those doing a substantial business. In the most successful voluntary groups, the sponsoring wholesaler and the retailer-members pay considerable attention to creating effective advertising and to improving store operating efficiency. The largest voluntaries are in the food industry, where there are such nation-wide organizations as *I.G.A.*, *Red and White*, and *Clover Farm Stores*. However, there are also voluntaries in other fields, such as hardware and variety merchandise.

Retailer cooperatives and voluntary groups have become very important distributors of convenience goods. In many cases, their buying power equals or exceeds that of the chains. In food retailing, for instance, members of retailer cooperatives and voluntary groups now have a greater sales volume than the corporate chain store systems. Buyers for the larger cooperatives and voluntaries have learned to drive just as hard a bargain with suppliers as their chain store counterparts. Thus, manufacturers have come to regard cooperatives and voluntaries in much the same light as the chains and consequently deal with them in almost identical fashion.

### Consumer Cooperatives

A consumer cooperative is a retail business owned and operated by ultimate consumers to purchase and distribute goods and services primarily

<sup>5</sup> D. J. Schwartz, *An Exploratory Analysis of the Development and Present Status of Voluntary and Cooperative Groups in Food Marketing* (Atlanta: Georgia State College of Business Administration, 1957), p. 31.

to the membership. The earliest known consumer cooperative was started in Scotland, but the modern form traces to an English cooperative founded in 1844—the Rochdale Society of Equitable Pioneers. This organization was the first to lay down the principles which have ever since served as the keys to successful operation of consumer cooperatives. These “principles,” which are really operating policies, are (1) open membership—any consumer is free to join, (2) democratic control—each member has but one vote regardless of the number of cooperative shares held, (3) limited interest is paid on capital invested by members, (4) all sales are made at prevailing market prices and for cash only, and (5) members receive patronage dividends proportionate to the purchases made from the cooperative.

Although there are some fairly large consumer cooperatives in the United States, their total impact on American retailing has been negligible. Perhaps the main reason why they have not been as successful in the United States as they have in Europe lies in the fact that other types of retailing institutions grew up here and provided the strongly competitive setting which kept retailing profits low. In Europe, the high and often exorbitant profits of retailers furnished the stimulus for consumers to band together and open their own retail stores. While the consumer cooperative movement was thriving and expanding in Europe, chain stores and their competitors in the United States were having to learn how to provide quality merchandise at low prices. While European retailers were still relying on high unit profits and low sales volumes, the newer American retail institutions were emphasizing low unit profits and high sales volumes. In other words, retailers in this country recognized early that the economies of mass marketing, like those of mass production, could only be realized through a combination of large sales and attractive prices.

Most U.S. consumer cooperatives are in the grocery retailing field. The main reason for this is that their organizers have probably been impressed with the large part food purchases play in total consumer spending. Most consumer cooperatives in the grocery field begin as small and inadequately financed enterprises housed in poorly situated buildings with scanty stocks and underpaid managements. These are formidable handicaps for any firm to contend with. They are especially difficult to overcome in the highly competitive grocery business, where the sensational successes of the chains and supermarkets have so dramatically demonstrated the importance of large size, adequate financing, well-planned inventory, and efficient management. It is small wonder, then, that consumer cooperatives have experienced rough sledding in the retail grocery field.

Consumer cooperatives stand a better chance of success when they are set up to handle merchandise lines other than groceries. For instance,

they have been highly successful in operating college and university bookstores. The consumer cooperative in this field is often more efficient than its privately-owned competitors, most of which are small independent stores. Furthermore, in marked contrast to grocery retailing where low unit profit margins are the rule, the book and school supply trade is characterized by relatively high margins. This combination of favorable factors enables many cooperative college stores to pay patronage dividends of as much as 15 per cent of members' purchases.

However, there is little motivation for consumers to organize cooperatives in non-food fields, chiefly because potential savings on small monthly expenditures per member seem hardly to justify the effort. Most cooperative college stores were organized to fill an existing "retail vacuum." At the University of Washington, for example, the University Book Store was organized in 1900 to help in overcoming three problems: (1) late arrival of text books causing students to get a late start in class work, (2) difficulty in getting faculty cooperation on book orders, and (3) the inconvenience of going to stores in downtown Seattle and the necessity of going to several stores because of incomplete stocks in individual stores. Existence of such "retail vacuums" provides at least one type of setting that is conducive to the successful establishment of consumer cooperatives.

### Supermarkets

The first supermarkets appeared in the early 1930's, during the depths of the Great Depression. The pioneer supermarket operators often began in vacant warehouses and, through the use of mass merchandise displays and heavy advertising, succeeded in transacting what were then tremendous volumes of business. They featured low prices and operated on a cash-and-carry basis. That the stores were physically unattractive was of little importance; widespread unemployment and shortages of purchasing power made the low-price appeal unusually attractive. The first operators of supermarkets were independents, but, by 1937, nearly all of the leading food chains were building supermarkets as fast as they could find suitable locations—and closing up three or four of their existing smaller stores to make way for each of the supermarkets they opened.<sup>6</sup> By this time, of course, the "cheapy" supermarkets located in vacant warehouses were rapidly giving way to more attractive supermarkets on sites more convenient to customers, and, as this new type of retailing idea caught on with more and more businessmen recognizing the great possibilities of supermarket operation, a revolution in food retailing gathered steam.

<sup>6</sup> G. M. Lebharr, *Chain Stores in America, 1859-1959* (New York: Chain Store-Publishing Corp., 1959), Centennial Edition, p. 32.

The basic characteristics and operating philosophy of the supermarket are indicated in its definition—a large retailing business unit selling mainly food and grocery items on the basis of the low margin appeal, wide variety and assortments, self-service, and heavy emphasis on merchandise appeal. Supermarkets were devised originally as food retailing businesses, and they continue to base most of their operations on the mass-selling of food and grocery items. However, in order to widen their merchandise appeal and, at the same time, improve their profit potentials, increasing numbers of supermarkets have added such non-food lines as drugs, household utensils, hardware items, and garden supplies. This trend toward “scramble merchandising,” together with the spreading habit of many consumers to shop only once or twice a week for groceries, has enabled the supermarket to increase the dollar value of the average order sold each customer on each trip to the store. To stimulate store traffic, the supermarket typically promotes its low prices through the heavy use of advertising, mass merchandise displays, and the use of premium and trading stamp plans. Because it needs a high sales volume for profitable operation, the supermarket requires large floor space, a layout designed to achieve maximum merchandise exposure, large merchandise stocks on the selling floor with readily accessible reserve stocks, and adequate check-out counters. In addition, it is important to provide check-cashing facilities and a parking lot of such size as to handle peak volumes of business.<sup>7</sup>

Except for the difference in merchandise lines, the supermarket and the discount house have a great deal in common. Both rely on the appeal of low prices, wide variety and assortments, self-service, and the handling of well-known brands of merchandise. Both seek to keep their prices down by combining operating expense economies with a high volume business in fast-selling items. Notice, however, that the supermarket is, by definition, a large retailing business unit whereas the discount house may be any size—from very small to very large. The larger discount house is the one most closely resembling the supermarket and, as a matter of fact, many new, larger discount houses have added grocery departments and are offering very tough competition to the supermarkets in their trading areas. Since a discount house, like a supermarket, must maintain a large over-all sales volume if it is to be able to offer its low prices, many are operating their grocery departments at no profit or even at a loss, con-

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<sup>7</sup> “Some supermarkets are successful without providing parking space. . . . The trend, however, is to provide more parking space. Early markets provided one square foot of parking space to one square foot of store space. This ratio increased to as much as two or three times as much parking space as space in the store. At this writing the supermarkets like to have a ratio of at least four to one.” P. D. Converse, *Fifty Years of Marketing in Retrospect* (Austin: Bureau of Business Research, The University of Texas, 1959), p. 66.

sidering them mainly as a means to getting people into the store and maintaining the required over-all level of sales. Nearby supermarkets have found it difficult to match the discount house's "non-profit" grocery policy—tough competition indeed!

Many of the buying practices of supermarkets are routine. Certain staples and nationally-advertised items are carried by nearly all supermarkets, e.g., the lines of Campbell's soups, Rice Krispies, and Underwood deviled ham. The responsibility for buying varies with the size and organizational structure of the company. Large supermarket chains have specialized buyers who bargain with and make routine purchases from suppliers, and store managers who requisition such items from warehouses. In smaller companies, a single individual often handles negotiations for all routine purchases. Managers of produce and meat departments often have authority to buy for their own departments. Supermarkets that belong to retailer cooperatives and voluntary groups usually make the bulk of their routine purchases through the wholesaling units of such organizations. Ordering and shelf stocking of certain items, such as crackers and cookies, frequently are handled by manufacturers' salesmen under the authorization of the owner, manager, or person responsible for buying.<sup>8</sup> The ordering and stocking of non-food lines, such as those handled by rack jobbers, also is often taken care of with minimum supervision by supermarket personnel.

#### *Discount Houses*

A discount house is a retailing business unit which features consumer durable items, competes on a low-price basis, and operates on a relatively low markup and a minimum of customer service. Discount houses range from small open showroom and catalogue type order offices all the way to full line, limited service, promotional stores which closely resemble and, actually, can be classified as department stores. Also included is the "closed door" or membership type of discount house which supposedly caters only to homogeneous groups such as union members, government employees, or teachers.<sup>9</sup> In fact, the term "discount house" is being used more and more in referring to any retail establishment whose main promotional emphasis is on selling nationally advertised merchandise at prices below those of conventional dealers.

Although some appeared in the late 1930's,<sup>10</sup> discount houses were neither numerous nor widespread until after World War II. After the

<sup>8</sup> F. J. Charvat, *Supermarketing* (New York: Macmillan, 1961), p. 76.

<sup>9</sup> R. D. Entenberg, "The Discount House—Panic or Panacea?" *Georgia Business*, Vol. 21, No. 4 (October 1961), p. 1.

<sup>10</sup> S. C. Hollander, "The Discount House," *The Journal of Marketing*, No. 1, Vol. XVIII (July 1953), p. 58.

first rush of postwar buying subsided, discount houses began to set up in the so-called "hardgoods" lines—i.e., appliances, furniture, and other consumer durables of relatively high unit price. Manufacturers of major appliances and other consumer durables, encouraged by the strong immediate postwar consumer demand for their products, had greatly expanded their production facilities. Before long, however, they recognized that their expanded facilities were capable of producing far more than their established outlets using traditional retailing methods could sell to ultimate consumers. These outlets were, for the most part, department stores and small independent dealers. Manufacturers either had to persuade these outlets to improve their selling efficiency or obtain more outlets to help in retailing the expanded production. It was in this setting that manufacturers began to turn to discount houses which could provide the needed additional sales volume.<sup>11</sup>

In the late 1940's and early 1950's, then, circumstances were ripe for the establishment and growth of the new discount houses. Traditional appliance outlets such as department stores and small appliance dealers had grown accustomed to high markups, often 35 or 40 per cent of the retail price, and they were also used to selling at manufacturers' full "list" prices. Furthermore, appliance manufacturers had promoted their brand names to the point where the consumer was no longer concerned whether the retailer would guarantee the quality of the product. Every reputable manufacturer now stood behind his products regardless of the outlets from which consumers bought them. Discount house operators found that they could sell appliances and other consumer durables profitably at prices ranging as much as 30 per cent below those of the traditional outlets. The traditional retailers were at first able to maintain their own total sales and profits, and, for a few years, did not put up much of a competitive battle. By the time they realized that they had to "come out slugging" and "meet or beat discount house prices," discount houses had already won great customer loyalty on the basis of their strong price appeal.<sup>12</sup>

Discount houses buy their merchandise stocks both from wholesale distributors and directly from manufacturers. Early in their growth, they did nearly all of their buying from distributors. Sometimes, so-called "legitimate" retailers, not wanting to compete on a price basis, put pressure on distributors to stop supplying the discounters. When their supplies are cut off, discount houses will either buy from other retailers,

11 E. Gudeman, *A Profile of Sears*, The Tobé Lecture Series, Harvard Business School, February 12, 1949, p. 15.

12 A. R. Oxenfeldt in *Discount House Operations*, hearings, Senate Small Business Committee, Subcommittee on Retailing, Distribution, and Fair Trade Practices, June 23, 24, and 25, 1958, p. 400.

either legitimate or discount types, on a cost plus five per cent basis, or work out exchange arrangements with other discount houses whose supplies have not yet been cut off.<sup>13</sup>

As discount houses grew larger and became important outlets for many consumer durables, and as chains of discount houses such as E. J. Korvette were organized, more and more manufacturers began to make direct sales to them. Eventually, discount houses may wind up with even more direct-buying privileges. Although discount houses, like the chains, are "hard" buyers, they are also "fast" buyers. Manufacturers appreciate a "fast" buyer when they find themselves with unexpectedly large inventories that more conventional retail outlets seem incapable of moving.<sup>14</sup>

### *Automatic Selling*

Automatic selling, or as it is more commonly known "automatic vending," involves the sale of goods or services to ultimate consumers through coin operated machines. Whereas most automatic vending machines are still coin operated, there are reports of promising experiments with machines that may accept paper currency. There are already machines which are capable of making change for one dollar bills, thus overcoming a longtime disadvantage of automatic vending—the inability to serve customers who do not have the proper change. Automatic selling is not a new method of retailing, for the Tutti-Frutti Company installed chewing gum machines at elevated railroad stations in the 1880's. Traditionally, the major portion of vending machine volume has and still comes from soft drinks, cigarettes, and candy. Two out of every ten candy bars sold are sold through vending machines, 16 out of 100 packs of cigarettes, and more than one out of four soft drinks.<sup>15</sup>

Among the many attempts that have been made to use vending machines for products other than soft drinks, candy, and cigarettes, those with packaged milk and ice cubes have been most successful. But many have failed. In 1950, for instance, Filene's, a Boston department store, installed 23 machines in the Boston Greyhound bus terminal selling goods ranging from men's hose and ties to ladies' panties and babies' rattles. After two years, the experiment was abandoned as a failure. The Grand Union supermarket chain has conducted a round-the-clock supplementary vending operation for certain grocery staples, but the company still calls it an "experiment."

<sup>13</sup> F. W. Gilchrist, "The Discount House," *The Journal of Marketing*, Vol. XVII, No. 3 (January 1953), p. 268.

<sup>14</sup> E. B. Weiss, "Marketing's Coming Readjustment to Low-Margin Retailing" (New York: Doyle-Dane-Bernbach Inc., 1957), p. 42.

<sup>15</sup> "How Will Vending Boom Affect Selling," *Printers' Ink*, October 30, 1959, p. 68.

Although automatic selling still accounts for less than one per cent of all retail sales—only \$2.1 billion out of an estimated \$220 billion total in 1958—vending machines are becoming increasingly important as outlets for many types of products. The National Automatic Merchandising Association estimates that there are about 5,600 vending machine operators in the United States operating more than 3.7 million machines selling products that literally range from soup to nuts. Vending machine volume expands with each new technological improvement in machine design and operation. The first coffee vending machine, for instance, was installed in 1946 and just twelve years later, in 1958, such machines were selling coffee at an annual rate of \$189 million. N.A.M.A. states that the average person now spends about \$12.50 on purchases from these machines each year. The association predicts that annual vending volume will double by 1965, that is rise to the \$4 billion level.<sup>16</sup> Probably this estimate is much too conservative for, judging from the rapid progress automation is making in other fields, technological advances in vending machines are very likely to come with increasing frequency in the years ahead.

### Shopping Centers

The Urban Land Institute defines a shopping center as "a group of commercial establishments, planned, developed, owned, and managed as a unit, with off-street parking provided on the property (in direct ratio to the building area) and related in location, size (gross floor area) and type of shops to the trade area that the unit serves—generally in an outlying or suburban territory."<sup>17</sup> Shopping centers are classified according to their size, which is determined by the area served and which, in turn, determines the kinds and variety of stores included.<sup>18</sup>

The *neighborhood center* is the smallest and most common type of shopping center. A supermarket is usually its focal point with the smaller stores geared to supply convenience goods and services (drug and hardware stores, beauty and barber shops, laundry and dry cleaning estab-

<sup>16</sup> *The Wall Street Journal*, Nov. 7, 1958, p. 24.

<sup>17</sup> "Shopping Centers Re-studied," *Technical Bulletin No. 30* (Washington, D.C.: Urban Land Institute, May 1957).

The American Marketing Association defines a shopping center as "a geographical cluster of retail stores, collectively handling an assortment of goods varied enough to satisfy most of the merchandise wants of consumers within convenient travelling time, and, thereby, attracting a general shopping trade." Unfortunately, the A.M.A. definition includes both planned and unplanned shopping areas. Unplanned shopping areas, usually called "shopping districts," are non-integrated, i.e., they have no overall plan with respect to the merchandise stocked by each retailer. In contrast, the shopping center defined by the Urban Land Institute is an integrated, planned unit. For that reason, the definition provided by the Urban Land Institute seems to be the most significant for purposes of this discussion.

<sup>18</sup> The discussion on kinds of shopping centers is adapted from: "Shopping Centers and New York State's Retail Economy," *New York State Commerce Review*, Vol. 12, No. 9 (September 1958), p. 2.



lishments, gasoline stations) to some 7,500 to 20,000 people living within six to ten minutes driving distance. Neighborhood centers may have only a dozen stores but the total area occupied, including parking space, is likely to range from four to ten acres. Generally, it is agreed that a neighborhood center is well-located if there are no strong competitors within about two miles.

The *community center* is a larger operation and usually features a variety store or a small department store in addition to the supermarket and other small stores also found in the neighborhood center. Thus, the community center provides a merchandise offering which includes a selection of shopping goods, such as clothing and house furnishings, as well as convenience goods. The community center serves a market of from 20,000 to 100,000 persons, and occupies from ten to thirty acres. According to experts in the field, the community center should not have strong competitors within a radius of three to four miles.

The *regional center* is the largest of all. One or even two large department stores provide its main drawing power which is further enhanced by up to 100 smaller stores. Some regional centers, though not all, include one or two supermarkets to add further to total shopping attractiveness. Shoppers, therefore, may select from a very wide range of goods. Regional centers are usually set up to serve 100,000 to 250,000 people living within a radius of five to six miles. Such centers, more closely resembling downtown shopping districts than the smaller centers, are slowly but surely changing consumer shopping habits, especially because they reduce the need or urgency to go downtown to shop.

Because of their relatively generous parking facilities, easy accessibility by automobile, and nearness to the suburban middle income market, regional centers now threaten both the central city's downtown shopping district and the older "main street" suburban business district.<sup>19</sup> One Cleveland retailer is on record as estimating that, of every \$20 million spent in shopping centers, \$10 million comes out of "downtown's hide."<sup>20</sup> Downtown merchants are pressing for measures to alleviate traffic congestions and also for improved parking facilities, but they are not likely ever to match the convenience of the outlying shopping centers. But, on the other hand, an outlying center cannot equal the strategic location of the downtown to serve a vast region, nor can it match the downtown's vast range and selection of goods and services.<sup>21</sup> It is not economically feasible, for instance, for regional centers to include stores selling many

<sup>19</sup> *An Analysis of the Cross County Shopping Center and its Impact on Established Shopping Areas*, Westchester County Department of Planning, October 1956, p. 1.

<sup>20</sup> *Business Week*, Dec. 5, 1959, p. 82.

<sup>21</sup> W. Applebaum and B. L. Schapker, *A Quarter Century of Change in Cincinnati Business Centers* (*The Cincinnati Enquirer*, August 1956), p. 32.

items bought mainly by the "carriage trade"—bracelets and earrings in the \$30,000 price class, fur pieces and coats selling at thousands of dollars apiece, expensive grand pianos, and collections of rare books. No regional center serves a large enough number of the kind of people who might want to buy such items, whereas downtown shopping districts in most large cities, because they draw in trade from a much wider area, are fully capable of supporting such retail stores. Note, too, that the items used as examples all fall into the specialty goods classification—consumers are willing to make a special purchasing effort in order to locate the stores which have such items for sale.

For the manufacturer, the main marketing significance of the planned shopping center lies in the fact that it is an integrated retail unit. Consumers often view the center as a single large shopping convenience and not as a conglomeration of individual stores each going its separate way. Recognizing this, shopping center developers sometimes restrict the classes of merchandise individual stores are permitted to handle. In other centers, a certain degree of controlled competition among stores handling similar merchandise lines is allowed. Thus, a manufacturer of lighting fixtures, accustomed to selling his line through both hardware stores and department stores, encounters three different distribution situations in shopping centers: (1) In some, the line is restricted to the hardware store, (2) in others, it is restricted to the department store, and (3) in still others, both the hardware store and the department store are free to handle the line. This same manufacturer may even find instances where shopping center branches of department stores are not permitted to handle his line even though the parent stores have represented the line for years. The great need for information about such situations explains why manufacturers should maintain close contact with their dealers operating, or who may be planning to operate, stores in shopping centers. In addition, the extensive use made of self-service in shopping centers has caused many manufacturers to redesign product packages and add more information to the labels. Furthermore, with the growing importance of the regional centers, manufacturers have been led to re-examine their advertising practices, especially with respect to advertising in media which are aimed specifically at the trading areas of shopping centers.

#### **FACILITATING AGENCIES IN MARKETING**

There are many institutions which make significant contributions to the process of marketing, but which may not be classified as marketing middlemen since they neither take title to goods nor negotiate purchases or sales. These institutions, known as facilitating agencies, assist in the performance of one or a number of the marketing functions but, as mentioned above, neither take title to goods nor negotiate purchases or sales.

Examples of such agencies are banks, railroads, storage warehouses, commodity exchanges, stock yards, insurance companies, industrial design consultants, graders and inspectors, advertising agencies, firms engaged in marketing research, cattle loan companies, furniture marts, and packers and shippers. We have listed below the marketing functions which we discussed in Chapter 3, together with samples of marketing facilitating agencies which generally assist in performing each function:

1. Product planning and development .....	Industrial design consultants
2. Grading and standardizing	Graders and inspectors
3. Buying and assembling ..	Stock yards Packers and shippers
4. Selling .....	Commodity exchanges Furniture marts Advertising agencies
5. Storage ... ..	Storage warehouses
6. Transportation .....	Railroads
7. Marketing financing .....	Banks Cattle loan companies
8. Risk bearing . . . . .	Insurance companies
9. Market information .....	Marketing research firms

It is worth emphasizing that marketing facilitating agencies are *not* marketing middlemen. Facilitating agencies are concerned neither with effecting transfers of title nor with negotiating such transfers, whereas marketing middlemen are always concerned with one or the other. Even though certain facilitating agencies (e.g., stock yards and advertising agencies) sometimes *assist* in performing the buying and selling functions, they neither negotiate nor effect transfers of title. Most marketing facilitating agencies, of course, assist with business activities other than buying and selling and, in these cases at least, it is clear that they do not qualify as marketing middlemen.

#### DISTRIBUTION CHANNELS

In the following discussion we will first consider a few of the more important problems confronting manufacturers in choosing channels of distribution; then, we will briefly analyze some channels of distribution in common use.

### ***Problems in Choosing Distribution Channels***

A manufacturer's role in the selection of distribution channels is primarily one of adjusting to the needs and expectations of buyers at each distribution level. At the retail level, these buyers are the ultimate consumers; they are not even remotely interested in the manufacturer's ideas as to which outlets should sell his products. Ultimate consumers buy from those retailers who are capable of best serving their needs. The discount house is an excellent example of this. In the late 1940's and early 1950's many manufacturers of nationally-advertised items refused to permit discount houses to handle their lines. Nevertheless, as we mentioned earlier, discount houses managed to obtain merchandise; ultimate consumers, in ever-increasing numbers, demonstrated that they preferred to buy such items from discount houses rather than from more conventional retailers. Manufacturers, realizing the hopelessness of trying to keep their products out of discount houses (and the potential loss in sales volume if they succeeded) relented, many of them actively seeking retail representation through discount houses.

At other distribution levels, buyers' preferences are equally important. Once the manufacturer determines which kinds of retailers will be most acceptable to ultimate consumers, he must find out the type of supplier from which retailers prefer to buy the product. Retailers may customarily buy directly from manufacturers or they may buy nearly all their stock from wholesalers. Whatever the normal buying pattern of retailers, a manufacturer is well-advised to make his product available through the same sources of supply.

Not only does the manufacturer have to make up his mind about the *kind* of middlemen he should use on each distribution level, he must also decide on *how many* middlemen there should be handling his product on each level. If he decides to sell directly to retailers, he must choose from among many different kinds of retailers; if he decides to use wholesalers, he will also have to choose from among the different kinds of wholesale institutions. Then, he attempts to determine how many retailers of the chosen types will be needed to reach the consumers he wants to reach and, assuming he decides to use wholesalers also, how many wholesalers of the chosen types will be required to reach all the retailers he desires to use. If we think of the different kinds of middlemen as kinds of "institutional" building blocks, as we did earlier in this chapter, we can say that the manufacturer must decide not only what kinds of building blocks to include in his distribution channel(s), but also how many of each kind he needs.

An example will shed additional light on the size and complexity of the manufacturer's problems in choosing distribution channels. A manufac-

turer of home appliances, seeking retail outlets, is faced with a choice of appliance stores, department stores, chain stores, furniture stores, and discount houses. From these, he must decide on appropriate outlets in every city and town where he wants his product to be sold at retail. Usually, appliance manufacturers do not try to achieve distribution through every available retail outlet in every community, but they must determine *which specific outlets* in each city and town will be likely to do the best selling job. Our appliance manufacturer could decide to sell only through one kind of retailer—possibly only through furniture stores. An alternative would be to adopt a more widely used policy—that of varying selection of outlets in each city and town according to the relative merits of local retailers. Finally, the manufacturer would have to contact all retailers he decided to use and persuade them to distribute his line in their areas.

We will analyze the manufacturer's problems in choosing distribution channels in much greater detail in a later chapter,<sup>22</sup> but the significant thing to recognize at this time is that the manufacturer must consider the interests of *outside* parties (final buyers of the product, and middlemen) before he makes this important decision. In other words, he is not free to make the channel-decision in a "vacuum." Only when there is a product shortage is there ever any excuse for a manufacturer to make unilateral channel-decisions and, even then, it is a questionable procedure. In this age of plenty, however, channel usage must be determined by the needs and expectations of final buyers and those at each distribution level. And it must be remembered that channels which serve well today may not do so tomorrow.

Marketing novices always ask why comparable manufacturers of similar products often use different distribution channels. Such a circumstance may be explained by any of four different reasons. First, it is not always possible for a manufacturer to use the channel he prefers if it is already being used by competitors. A manufacturer of men's suits, for example, may want to distribute his line through the leading men's store in each town, but many such retailers may be fully satisfied with competitive lines already in stock. Confronted with this sort of situation, the manufacturer may have to compromise in some communities and accept second best men's stores, or the men's departments of department stores. Second, some manufacturers, ignorant of ultimate consumers' preferences for certain outlets, convince themselves that the superiority of their products will attract ultimate consumers to the outlets they use. Third, some manufacturers simply disregard ultimate consumers' desires and use outlets which are easiest to obtain. And fourth, when two manufacturers of similar products use different channels, each may actually have made the

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<sup>22</sup> See Chapter 17.

"best" choice, because each may be successfully catering to different market segments. When a manufacturer is unable, for one reason or another, to use what is for him the best possible channel, he may still succeed in moving his goods through another channel and into the hands of some ultimate consumers. But he may not be as successful as he would have been had he been able to use the best channel or combination of channels.

### *Channels of Distribution in Common Use*

**DIRECT-TO-CONSUMER OR USER.** There must always be at least two levels in even the shortest distribution channel. They are the producer and the ultimate consumer or industrial user. The direct producer-to-industrial user channel is used in marketing many types of industrial goods. There are several reasons for this: Many industrial products have markets composed of relatively few potential users. The users of particular types of industrial products tend to be clustered in only a few market areas. Some industrial products have special servicing and installation requirements which the manufacturer can best provide. Others are so technical that manufacturers must employ sales engineers to deal directly with prospective users. Finally, in many cases, industrial users insist on being permitted to buy directly and are able to buy in quantities large enough to make direct sales by producers economically feasible.

The direct producer-to-ultimate consumer channel is not nearly as important, but many consumer products are being marketed this way. Farmers sometimes deal directly with consumers at roadside stands or from stalls in public markets. Small businesses, such as bakeries and dairies, and larger businesses, such as the tire manufacturers, quite often sell directly to consumers, either through their own retail outlets or on a house-to-house basis. There are even a few manufacturers, in such lines as shoes and shirts, who sell directly to consumers through mail order departments. However, few manufacturers of consumer products rely wholly or even principally on the producer-to-ultimate consumer channel. The reasons are fairly obvious: ultimate consumers are numerous, widely scattered, and accustomed to buying in very small quantities.

**INDIRECT DISTRIBUTION THROUGH AGENT MIDDLEMEN.** Some producers use agent middlemen as intermediaries between themselves and the next level of distribution. (Agent middlemen, it should be remembered, generally operate at the wholesale level.) Agent middlemen are much used in marketing agricultural produce, partly because most farmers are too small to handle their own distribution efficiently and partly because the main growing areas are often geographically apart from the larger markets.

In the marketing of manufactured products, both industrial and consumer goods, agent middlemen are used usually, though not exclusively,

by manufacturers who want to rid themselves of much of the marketing task. A manufacturer's entire output may be turned over to one or a small number of agent middlemen for marketing, in which case the manufacturer's distribution channel problem is reduced to that of selecting and persuading certain agents to serve as his representatives. In other instances, the manufacturer may use agents to market his product in some areas, generally areas with limited market potentials, and either use his own sales force or sell directly to merchant middlemen in the remaining areas.

When agent middlemen are used, they negotiate the transfer of legal title to the producer's merchandise with institutions active on the next level of distribution. In the case of consumer goods, these negotiations are carried on with either merchant wholesalers or retailers or both, or the agent makes arrangements for further negotiations to be handled by other types of agent middlemen situated further along the distribution channel and nearer the ultimate consumer. For such products as furniture, which are usually sold through a limited number of retail outlets, the agent ordinarily negotiates directly with retailers. For products sold through large numbers of retail outlets, such as most food and grocery items, the agent usually negotiates with merchant wholesalers who, in turn, sell to retailers. However, in marketing food products, agents may also deal directly with such large volume retailers as the grocery chains and retailer co-operatives. In the marketing of industrial goods, agents usually negotiate directly with industrial users but, in some lines such as small hand tools, it is common for them to negotiate with merchant wholesalers, known as industrial distributors or mill supply houses, which, in turn, sell to the industrial users.

**MANUFACTURER TO RETAILER TO ULTIMATE CONSUMER.** This is one of the most common distribution channels used for reaching the consumer market. Manufacturers using it generally have some compelling reason for avoiding wholesale middlemen: Their products may be perishable, either physically or fashion-wise, hence speed in distribution is essential. The retailers involved may be predominantly large (such as chains, department stores, and mail-order houses) and, as a matter of policy, refuse to buy through wholesalers. The retailers handling the product may be located near each other, thus making it convenient for the manufacturer to sell to them directly. The available wholesalers may be unable or unwilling to provide the type and amount of promotional support that the manufacturer feels his product requires. Finally, the manufacturer may simply desire closer contact with ultimate consumers than that afforded through channels containing more distribution levels.

Manufacturers distributing their products directly to retailers must be able to finance the inventories that would otherwise be carried by mer-

chant wholesalers. Furthermore, the manufacturer ideally should either have a wide enough line to permit his salesmen to write fairly large orders, or a narrower line of products generally ordered by retailers in large quantities. If the product line is not ordinarily purchased in large quantities by individual retailers, the manufacturer should have some other strong reason, such as those mentioned earlier, for selling directly to retailers.

**MANUFACTURER TO MERCHANT WHOLESALER TO RETAILER TO ULTIMATE CONSUMER.** This consumer goods channel is often referred to as the "traditional" or "orthodox" distribution channel. A manufacturer finds it suitable under some or all of the following conditions: the manufacturer has a narrow product line; he is unable to finance distribution direct to retailers or can put the necessary funds to more productive use elsewhere; retail outlets are numerous and widely dispersed; wholesalers are able and willing to provide strong promotional support or the product does not require such support; the products are staples, not subject to physical or fashion deterioration; the manufacturer's advertising to ultimate consumers exerts a strong pull in causing retailers to stock the product. Manufacturers who use this channel but desire closer contact with retailers often employ "missionary" salesmen who, while calling on retailers ordinarily refer any orders they obtain to local wholesalers for filling and delivery.

**MANUFACTURER TO MERCHANT MIDDLEMAN TO INDUSTRIAL USER.** This distribution channel is used by many producers of such industrial items as small tools and other standard pieces of equipment. These are products of comparatively small unit value which are used by numerous and diverse industrial establishments. Merchant middlemen serving the industrial market, though their operations in many ways resemble those of consumer goods wholesalers, sell directly to industrial users. Such merchant middlemen are known to the trade as industrial supply houses, mill supply houses, industrial hardware distributors, equipment distributors, and by other similar titles.

### CONCLUSION

We have placed particular stress in Chapters 4 and 5 on the dynamic nature of marketing institutions. In the past two hundred years, the rate of institutional change has greatly accelerated. The general store and the general merchandise wholesaler, for instance, evolved, reached their peaks of importance, and have gradually almost faded away. The department store, the mail-order house, and chain store systems appeared, scored great successes, and then



settled back as significant but not dominating features of the retail scene. Newer institutions such as the rack jobber, the supermarket, the planned shopping center, and the discount house, probably have not yet grown to full maturity. Traditional institutions, such as the general line wholesaler and the independent store, have had to modernize their operating methods in order to stay in business.

Many of these changes in marketing institutions and their operating characteristics represent a continuation of long-range trends; a few represent a reversal of previous trends. They have come about in almost all cases as the result of attempts to adjust operating methods more closely to the often changing needs and expectations of the market. Institutional evolution and change can be expected to continue, perhaps at an even more rapid rate, with only those institutions capable of adjusting to the changing characteristics of markets likely to survive.

The implications for the manufacturer are clear. There must be continuing adjustments made in channels of distribution because the institutions that make up the channels are themselves constantly changing. But, other factors also contribute to the manufacturer's distribution channel problems. Since channels are methods of reaching markets, changes in markets (as described in Chapter 2) require corresponding changes in distribution channels. Similarly, changes in products or in consumers' or users' attitudes toward products may require changes in channels. Thus, when the outboard motor became more than an item of equipment for fishermen, it became necessary to broaden its distribution. Activities of competitors determine the aggressiveness of promotion sometimes necessary to sell a product successfully, so changes in competitive action may require changes in channels of distribution. For all these reasons, manufacturers must regularly re-evaluate their channels of distribution.

#### QUESTIONS AND PROBLEMS

1. When direct (door-to-door) selling costs run as high as 60 per cent of selling price, is it really possible, in your opinion, to justify this method of distribution from a cost standpoint? Please explain.
2. Would you agree that in most instances the small independent retailer is an uneconomical operation, i.e., the proprietor could earn more money working the same number of hours for someone else? Why do such operations continue?

3. The main reason for patronizing mail-order houses in the nineteenth century was inaccessibility of other buying sources. What would you say is the main reason for patronizing such outlets today?
4. The future of the department store depends on the continuing demand on the part of the consumer for services, such as credit, delivery, and many more exotic ones, and his willingness to pay for these services. Do you agree?
5. Does the fact that chain stores are horizontally integrated constitute their main competitive advantage? What other important factors have contributed to their success?
6. Can you explain why producer cooperatives have been so much more successful than consumer cooperatives in the United States? \*
7. Supermarkets are described as integrated marketing institutions. What kind of integration is represented by this kind of store? Why should independent supermarkets find it desirable to be members of voluntary chains?
8. Some of the new discount houses have been described as soft goods supermarkets. Is this description accurate? How similar are the operating methods of the two types of institutions (discount houses and supermarkets)?
9. Does the evolution of large, planned shopping centers spell the ultimate elimination of downtown shopping centers? In what ways do downtown merchants have an advantage over merchants in the shopping centers?
10. Can you foresee the possibility that all convenience goods may eventually be sold in vending machines? Comment.
11. The manufacturer does not merely select the middlemen in his channel of distribution; this is a two-way process involving also decisions by the middlemen. Please explain this statement.
12. When the manufacturer sells to the consumer through his own retail outlets, is this really a manufacturer-direct-to-consumer channel of distribution, or is it in essence the same as the manufacturer-to-retailer channel? Why?
13. Agent middlemen provide the ideal method of distribution for producers who are ignorant of or uninterested in marketing. Do you agree? Why?
14. Whether a manufacturer sells directly to retailers or uses wholesalers depends primarily on his financial strength. Discuss.

15. All manufacturers of industrial goods should work toward the ultimate goal of selling direct to users, because industrial users prefer to buy in this manner. What is wrong with this reasoning?
16. If a manufacturer faces a conflict of interest between loyal traditional outlets and new types of outlets, how should he choose between them, e.g., softgoods supermarkets vs. department stores?

## PART TWO

# **The Marketing Environment**

THE CHANGING PATTERN OF MARKETING

ECONOMIC DETERMINANTS OF DEMAND

PSYCHOLOGICAL FACTORS AFFECTING CONSUMER DEMAND

SOCIOLOGICAL FACTORS AFFECTING CONSUMER DEMAND

LEGAL RESTRAINTS

THE  
CHANGING  
PATTERN  
OF  
MARKETING

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Two sets of forces make marketing an endlessly changing activity. First, there are the constantly interacting economic, sociological, psychological, and political forces which represent the “uncontrollable” marketing factors—uncontrollable because they cannot be appreciably influenced by any individual business enterprise. These are the *underlying* causes for continual change in the markets themselves. The second set of forces is put in motion by individual firms as they make continual adjustments in the “controllable” marketing factors, such as changes in prices, introduction of new products or remodeling of old products, and changes in promotional strategy. The un-

controllable factors both cause marketing opportunities to exist and set the limits within which firms may apply the controllable factors in their efforts to capitalize on marketing opportunities. In turn, the impact of differing applications of the controllable factors makes for further changes in the uncontrollable factors. The result is that every aspect of marketing is characterized by endless change.

Although the individual marketing manager can obviously exert little influence over the uncontrollable factors, he must know a good deal about them. He must not only be familiar with their general nature; he must also be consistently alert for changes in them which might affect the application of marketing factors he *can* control. Changes in uncontrollable factors and in the way they interact mean not only changes in markets but changes in his marketing problems. Changes of this kind may even result in significant alterations in the operations of wholesale and retail marketing institutions. From the standpoint of the marketing manager, then, the uncontrollable factors may cause changes both in markets and in the ways in which markets may best be reached.

Marketing action may be compared with the action that takes place when a series of stones are tossed into a pool of water. Each stone causes a ripple which results in a whole series of ripples, each succeeding ripple further removed from the point of impact. In marketing, the uncontrollable factors, like the stones, cause the initial ripples and the market begins to change. These market changes result in changes among retailers, then among wholesalers, and finally among manufacturers. In other words, marketing changes usually start at the consumers' end of the distribution channel and work back to the manufacturers' end. In this part of the book, Part Two, we will concentrate on the various uncontrollable factors—economic, sociological, psychological, and political—which cause changes in markets. In the next part, Part Three, we will discuss marketing decision-making and the tools necessary to make such decisions, and in Part Four we will concentrate on management decisions with respect to the various controllable factors—organization, products, distribution, pricing, and promotion. In this chapter, we provide essential background materials on the historical development of marketing and the changing market.

#### **HISTORICAL DEVELOPMENT OF MARKETING: THE MARKETING REVOLUTION**

There was a time when producers considered marketing a relatively unimportant side-line activity. Much of what they made was made to order and, in effect, was sold before it was manufactured. What they did produce in anticipation of receiving orders, they disposed of by selling directly from their workshops or by displaying their goods in public marketplaces. Because these producers were in close contact with their markets, they were almost instinctively aware of consumer preferences. Their day-to-day

contacts with their customers made it easy for them to anticipate the demand for their products. Furthermore, their skills were manufacturing skills; since manufactured goods of any kind were generally in short supply, there were few problems in selling and little selling skill was necessary.

As manufacturers began to increase their output, and as they switched from producing to order to producing in anticipation of orders, local markets became too small to absorb all that was produced. Selling problems were beginning to be important. But most manufacturers still preferred to concentrate on making products rather than selling them. Many felt that their products were in certain ways unique and could "sell themselves." However, most manufacturers did realize that their products had to be made available for sale in non-local markets. Some handed the entire selling task to exclusive sales agents who specialized in distributing products to wholesale and retail middlemen scattered in many markets. Most dealt with limited numbers of wholesalers who assumed the responsibility for selling the products to retailers in their selling areas. But even where the products were sold to wholesalers, manufacturers considered marketing far less important than manufacturing. Wholesalers and retailers did nearly all of the marketing work and, for the most part, manufacturers were happy to leave it that way.

During this period, which lasted until early in the twentieth century in the United States and much more recently in most other countries, economic conditions permitted manufacturers to devote little attention to marketing. The economy, although growing rapidly, was still primarily agrarian and supplies of manufactured goods were rarely large enough to meet the demand. Consumers were effectively forced to accept whatever goods were made available. Under these conditions, manufacturers could afford to concentrate on manufacturing and leave marketing primarily to the middlemen.

During the first three decades of the twentieth century, industry after industry adopted mass production techniques with sometimes spectacular increases in production. By the early 1930's the supply of many manufactured goods was exceeding the demand. It was common for manufacturers to find themselves faced both with excess production capacity and increasing competition for customers.

In their efforts to meet rising competition, manufacturers began paying more attention to marketing. In the consumer goods field, manufacturers tried to establish closer contacts with retail outlets, either through setting up sales forces to sell directly to retailers or through adding missionary salesmen to assist wholesalers in promoting the products among retailers. A few manufacturers (e.g., in petroleum and shoe marketing) opened their own retail outlets, thus establishing direct contact with ultimate consumers. In the industrial goods field, manufacturers made similar moves in order to gain closer contacts with industrial users. Both in consumer goods



and industrial goods industries, manufacturers also stepped up the promotion of their products through advertising.

During the depression of the 1930's, more and more top-managements began discovering that something else had to be done about marketing. Improved contacts with middlemen and increased advertising were not enough to ease the intense competitive situation. In addition, shrinkages in consumer purchasing power were causing declines in the demand for all sorts of products. The situation was even more serious in many industrial goods industries where demand all but disappeared. Many companies became convinced that they had to re-establish contact with consumers and users. Manufacturers who had formerly successfully measured the pulse of the market on an informal basis found that, with the addition of layers of middlemen between them and their customers, they no longer had an instinctive feeling for the customers' wants and needs. As a result, marketing research techniques came into wider use.

Realization that organizational changes were also needed came more slowly but, by the late 1940's and early 1950's, a growing number of firms were making such changes. Companies had set up separate but related departments to handle selling, advertising, sales promotion, and marketing research. Some companies drew these together into a single "marketing" division under the control of a marketing manager or marketing vice-president. In other companies, certain executives were made brand managers and given complete responsibility for marketing individual products or groups of products; thus, the brand manager's responsibilities cut across areas of activity which were once considered the exclusive provinces of separate departments. Under both new types of organizational arrangement, it was clear that the trend was away from production-oriented management, and toward marketing-oriented management. This change in philosophy and in organization has been called "the marketing concept." Under this concept, important company operations are geared primarily to the market and to the wants and desires of consumers. Greater numbers of consumer goods companies have adopted the marketing concept, but industrial goods companies are also beginning to adopt it. For example, the marketing vice-president of International Minerals and Chemicals Corporation, a producer of phosphates and potash sold to manufacturers of fertilizers, has written the following: <sup>1</sup>

We have become a truly customer-oriented company, and our marketing concept is successfully translated into daily work activity. This spirit has permeated our customer groups, and our image among them is one of productiveness and assistance—the company with a constructive program to help the customer through trying times.

<sup>1</sup> A. E. Cascino, "A Case Study in Marketing Management," *Business Horizons*, Vol. 2, No. 3 (Fall, 1959), p. 60.

*Marketing History of The Pillsbury Company*

The emerging importance of marketing in a consumer goods company is well-illustrated by the experience of The Pillsbury Company. The marketing history of this company has been vividly described as follows:<sup>2</sup>

Here is the way the marketing revolution came about at Pillsbury. The experience of this company has followed a typical pattern. There has been nothing unique, and each step in the evolution of the marketing concept has been taken in a way that is more meaningful because the steps are, in fact, typical.

Today in our company the marketing concept finds expression in the simple statement, "Nothing happens at Pillsbury until a sale is made." This statement represents basic reorientation on the part of our management. For, not too many years ago, the ordering of functions in our business placed finance first, production second, and sales last.

How did we arrive at our present point of view? Pillsbury's progress in the marketing revolution divides neatly into four separate eras—eras which parallel rather closely the classic pattern of development in the marketing revolution.

*1st Era—Production Oriented.* First came the era of manufacturing. It began with the formation of the company in 1869 and continued into the 1930's. It is significant that the *idea* for the formation of our company came from the *availability* of high-quality wheat and the *proximity* of water power—and not from the availability and proximity of growing major market areas, or the demand for better, less expensive, more convenient flour products.

Of course, these elements were potentially present. But the two major elements which fused in the mind of Charles A. Pillsbury and prompted him to invest his modest capital in a flour mill were, on the one hand, wheat, and, on the other hand, water power. His principal concern was with production, not marketing.

Our company philosophy in this era might have been stated this way: "We are professional flour millers. Blessed with a supply of the finest North American wheat, plenty of water power, and excellent milling machinery, we produce flour of the highest quality. Our basic function is to mill high-quality flour, and of course (and almost incidentally) we must hire salesmen to sell it, just as we hire accountants to keep our books."

The young company's first new product reveals an interesting example of the thinking of this era. The product was middlings [a by-product of the wheat milling process in the production of flour] . . . Millfeed, as the product

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<sup>2</sup> This material is taken from an article by Mr. Robert J. Keith, executive vice-president, consumer products area, The Pillsbury Company. See: R. J. Keith, "The Marketing Revolution," *The Journal of Marketing*, Vol. 24, No. 3 (January, 1960), pp. 35-38.

came to be known, proved a valuable product because it was an excellent nutrient for cattle. But the impetus to launch the new product came not from a consideration of the nutritional needs of cattle or a marketing analysis. It came primarily from the desire to dispose of a by-product! The new product decision was production oriented, not marketing oriented.

*2nd Era—Sales Oriented.* In the 1930's Pillsbury moved into its second era of development as a marketing company. This was the era of sales. For the first time we began to be highly conscious of the consumer, her wants, and her prejudices, as a key factor in the business equation. We established a commercial research department to provide us with facts about the market.

We also became more aware of the importance of our dealers, the wholesale and retail grocers who provided a vital link in our chain of distribution from the mill to the home. Knowing that consumers and dealers as well were vital to the company's success, we could no longer simply mark them down as unknowns in our figuring. With this realization, we took the first step along the road to becoming a marketing company.

Pillsbury's thinking in this second era could be summed up like this: "We are a flour-milling company, manufacturing a number of products for the consumer market. We must have a first-rate sales organization which can dispose of all the products we can make at a favorable price. We must back up this sales force with consumer advertising and market intelligence. We want our salesmen and our dealers to have all the tools they need for moving the output of our plants to the consumer."

*3rd Era—Marketing Oriented.* It was at the start of the present decade (the 1950's) that Pillsbury entered the marketing era. The amazing growth of our consumer business as the result of introducing baking mixes provided the immediate impetus. But the groundwork had been laid by key men who developed our sales concepts in the middle forties.

With the new cake mixes, products of our research program, ringing up sales on the cash register, and with the realization that research and production could produce literally hundreds of new and different products, we faced for the first time the necessity for selecting the best new products. We needed a set of criteria for selecting the kind of products we would manufacture. We needed an organization to establish and maintain these criteria, and for attaining maximum sale of the products we did select.

We needed, in fact, to build into our company a new management function which would direct and control all the other corporate functions from procurement to production to advertising to sales. This function was marketing. Our solution was to establish the present marketing department.

This department developed the criteria which we would use in determining which products to market. *And these criteria were, and are, nothing more nor less than those of the consumer herself.* We moved the mountain out to find out what Mahomet, and Mrs. Mahomet, wanted. The company's purpose was no longer to mill flour, nor to manufacture a wide variety of products, but to satisfy the needs and desires, both actual and potential, of our customers.

If we were to restate our philosophy during the past decade as simply as possible, it would read: "We make and sell products for consumers."

*The Brand-Manager Concept.* The first move was to transform our small advertising department into a marketing department. The move involved far more than changing the name on organizational charts. It required the introduction of a new, and vitally important, organizational concept—the brand-manager concept.

The brand-manager idea is the very backbone of marketing at Pillsbury. The man who bears the title, brand manager, has total accountability for results. He directs the marketing of his product as if it were his own business. Production does its job, and finance keeps the profit figures. Otherwise, the brand manager has total responsibility for marketing his product. This responsibility encompasses pricing, commercial research, competitive activity, home service and publicity coordination, legal details, budgets, advertising plans, sales promotion, and execution of plans. The brand manager must think first, last, and always of his sales target, the consumer.

Marketing permeates the entire organization. Marketing plans and executes the sale—all the way from the inception of the product idea, through its development and distribution, to the customer purchase. Marketing begins and ends with the consumer. New product ideas are conceived after careful study of her wants and needs, her likes and dislikes. Then marketing takes the idea and marshals all the forces of the corporation to translate the idea into product and the product into sales.

In the early days of the company, consumer orientation did not seem so important. The company made flour, and flour was a staple—no one would question the availability of a market. Today we must determine whether the American housewife will buy lemon pudding cake in preference to orange angel food. The variables in the equation have multiplied, just as the number of products on the grocers' shelves have multiplied from a hundred or so into many thousands.

When we first began operating under this new marketing concept, we encountered the problems which always accompany any major reorientation. . . . The idea was almost too powerful. The marketing concept provided its worth in sales, but it upset many of the internal balances of the corporation. Marketing-oriented decisions resulted in peaks and valleys in production, schedules, labor, and inventories. But the system worked. It worked better and better as maverick marketing men became motivated toward tonnage and profit.

*4th Era—Marketing Control.* Today marketing is coming into its own. Pillsbury stands on the brink of its fourth major era in the marketing revolution.

Marketing today sets company operating policy short-term. It will come to influence long-range policy more and more. Where today consumer research, technical research, procurement, production, advertising, and sales swing into action under the broad canopy established by marketing, tomorrow

capital and financial planning, ten-year volume and profit goals will also come under the aegis of marketing. More than any other function, marketing must be tied to top management.

As the marketing revolution gains momentum, there will be more changes. The concept of the customer at the center will remain valid; but business must adjust to the shifting tastes and likes and desires and needs which have always characterized the American consumer.

... modern business must anticipate the restless shifting of buying attitudes, as customer preferences move north, south, east, or west from a liquid center. There is nothing static about the marketing revolution, and that is part of its fascination. The old order has changed, yielding place to the new—but the new order will have its quota of changes, too.

At Pillsbury, as our fourth era progresses, marketing will become the basic motivating force for the entire corporation. Soon it will be true that every activity of the corporation—from finance to sales to production—is aimed at satisfying the needs and desires of the consumer.

#### THE CHANGING MARKET

In this section, we examine some of the pieces of evidence which indicate that the American market is a changing market, and consider a few fundamental causes of market change. Our intent here is only to survey these changes and causes. In the four chapters following, we will discuss in greater detail the various aspects of the changing market.

Since people make up markets, population factors are important contributors to market change. Growth in total population means more consumers and a larger market, and the American population is increasing at the net rate of one new person every eleven seconds. Shifts in the age distribution of the population result in changes in the nature and strength of the demand for many types of products; and both ends of the age distribution, the under-14 age group and the over-65 age group, are accounting for increasing shares of the total population. Roughly one-fifth of the nation's families move every year, and, although some of these moves merely represent shifts within the same neighborhood, many represent shifts of geographical distribution of the population or shifts between rural, urban, and suburban locations. Both of these long-range trends are important to marketing. Shifts in the geographical distribution of population, such as the long-range movement from east to west, create changes in demand and market potential in various parts of the nation. This explains why California is expanding in importance as a market while some New England States are static or even declining in importance. Shifts of population between rural, urban, and suburban areas are important to marketing because in many ways these constitute different markets. Al-

though all three groups buy clothing, they don't in every instance buy similar clothing, and the same is true for many of their other purchases. Shifts between these areas have been striking in recent years. Since 1950, nearly four-fifths of total population growth has been in the metropolitan areas, and more than four-fifths of metropolitan growth has been in the suburbs. The market for durable products, such as household appliances, is closely related to the formation of new households, and the number of households, now approximately 51 million, will rise to an estimated 61 million by 1970. These are only some of the many population changes that are resulting in significant changes in the American market.

Many significant market changes are caused by changes in the size and distribution of income. Purchasing power is essential for the conversion of consumer desires into market demand, and income is the most important source of purchasing power. In 1910, total consumer income was about \$30 billion, of which two-thirds was spent for food, clothing, and shelter, and one-third for discretionary items between which the consumer can make choices, e.g. to buy a television set or an automatic washing machine. By 1959, only about half of the \$300 billion spent by consumers was for food, clothing, and shelter, and approximately \$150 billion was available for so-called discretionary spending. In a statistical study of family expenditures by Ernst Engel in 1857, it was demonstrated that expenditures for food do not keep pace with rises in income. The recent Life Study of Consumer Expenditures confirmed Engel's findings (see Table 2.2, Chapter 2), demonstrating that as incomes move above the subsistence level, families increase their dollar expenditures on food but reduce the percent of total income allocated to food in order to buy luxuries they were previously unable to afford. Thus, not only is the trend toward larger total incomes, but consumers are spending relatively less on necessities and relatively more on luxuries. There is also a trend toward an evening out of income-level among consumers, a trend which is resulting in mass markets for many items, such as motorboats—luxuries which, in the recent past, only a few could afford. A few generations back, income distribution was like a pyramid with the vast bulk of the incomes at the pyramid base. Today the pattern of income distribution is being reshaped into the form of a barrel and, by 1970, this barrel will bulge in the middle \$5,000-\$10,000 income bracket with more non-farm families in the over \$10,000 class than in the under \$5,000 class. By 1970, it is predicted that there will be 12 million incomes over \$10,000, 10 million under \$5,000, and 26 million between \$5,000 and \$10,000.<sup>3</sup> The present median annual income of non-farm families, a little more than \$6,000 and rising by about two per cent

<sup>3</sup> N. H. Rogg, "The Sixties—Decade of Change and Choice," *The New York Times*, October 11, 1959, Section 10, p. 14.

a year, should exceed \$7,000 in 1970. Thus, large amounts of consumer purchasing power, more evenly distributed among the population, should continue to result in significant changes in the market for all kinds of consumer goods.

The changing status of the American woman has had profound effect on the American market. The reduction of social and economic pressures against working wives has greatly increased the number of married women in the work force. Prior to World War II, when war work was considered a patriotic duty, the wife's place was generally considered to be in the home with her children. In addition, during the depression of the 1930's, the scarcity of jobs created pressures against wives of employed men taking jobs from unemployed men. When the social stigma and the economic barriers were removed, the number of working wives increased rapidly. Well over half of the 23 million women in the work force today are married; hence, a great number of households have two incomes rather than one. Since it is rare for a wife's income to be set apart from that of her husband, the spending habits of such a family tend to match those of a family with equivalent income from a single source. In other words, more money is left over to spend on discretionary items. Also, the modern "emancipated woman" is very different from the home-tied woman of a half-century ago. Fifty years ago, most women welcomed the chance to go shopping as a change from household routine and an opportunity to see a bit of the world outside the home. Thus, they usually shopped at a leisurely pace. Today, not many housewives are isolated from the outside world. Many have full-time jobs outside the home, and many of those who do not have jobs are busy in community activity. Nearly all women are in constant touch with the outside world through radio and television. As a result of all these outlets to the outside world, women no longer consider shopping an excursion, but rather as a chore to be disposed of as quickly and efficiently as possible. Because of this changed attitude toward shopping, the typical consumer now shops for groceries only once, or at most twice a week. For the same reason, women are far less willing to shop in crowded downtown shopping areas. There also is increasing "togetherness" in shopping, as wives have convinced their husbands that much shopping should be a joint responsibility. This factor, along with the large number of working wives, has forced many retailers to keep their stores open for evening shopping. Studies show that families shopping together buy a greater variety of items and spend more money on each shopping trip than when either husband or wife shops alone.

American society is undergoing a number of significant changes, and the repercussions of these are showing up as market changes. First, more people have more leisure time and, at the same time, rising incomes make

it possible for more people to enjoy their leisure time.<sup>4</sup> One businessman summed up this change as follows: "...People have ceased to be producers for much of their lives and have become instead active consumers for all the necessities and luxuries their increased leisure calls for. For a longer and a larger part of our lives we cease to produce and become insistent customers."<sup>5</sup> The old Puritan dictum that idle hands make mischief is being overthrown, but the Puritan influence still remains. People refer to "active" leisure rather than just leisure—the "active" disassociating leisure from the guilt-loaded idea of loafing.<sup>6</sup> The result of greater leisure time has been greater markets for all sorts of recreation products. The forecasts are for steady five-to-ten per cent annual increases in the various segments that make up the vast market for leisure-oriented products.<sup>7</sup> With leisure markets accounting for larger shares of total consumer spending, demand for certain other products has been diminishing, or, at best, remaining static. For instance, one executive is quoted as saying "we have seen more families become boat-owners than own dishwashers, garbage disposers and room air conditioners combined. And yet 15 million homes have extremely obsolete refrigerators and 90 per cent of all refrigerators require the homemaker to defrost them."<sup>8</sup>

A second change in American society has involved a new attitude toward debt. Ever since the great depression of the 1930's, less and less stigma has been attached to buying on credit. Fewer people accumulate savings in order to pay cash for such products as television sets, major household appliances, furniture, and automobiles. Many "cash" buyers borrow from banks, finance companies, and other lenders, so, in effect, they also buy on credit but make their payments to lenders rather than directly to sellers. Buying on credit has become a way of life for millions, including many who could pay cash but prefer credit buying. Along with

<sup>4</sup> The late Sumner Slichter, distinguished economist, however, was among those contending that this is a situation which cannot go on forever. His argument essentially was that ultimately increased leisure would mean reduced personal incomes and consequently reduced sales for some products. For instance, if the four-day week were adopted, Slichter predicted that there would be gains in sales of industries producing inexpensive articles which could be used in leisure time—such as books, tobacco, inexpensive fishing gear, and small gardening tools. Industries which would experience sales losses would be those producing articles that cost so much that they would be bought in smaller quantities under a four-day week—such as cars, swimming pools, greenhouses, and motion picture cameras. For some stimulating food for thought, see: S. Slichter, "How the Four-Day Week Would Affect U.S. Marketing," *Printers' Ink*, October 9, 1959, pp. 68-69.

<sup>5</sup> D. M. Hobart, "Modern Leisure and Modern Markets," in *Report of the Twenty-Ninth Boston Conference on Distribution* (Boston: Retail Trade Board, 1957), p. 23.

<sup>6</sup> T. Levitt, "Blue-Skies Approach to Tomorrow's Marketing," *Business Horizons*, Vol. 1, No. 2 (Spring 1958), p. 124.

<sup>7</sup> See: "\$41-billion for Fun.," *Printers' Ink*, July 10, 1959, p. 25.

<sup>8</sup> J. W. Craig, vice-president and general manager, Appliance Division, Westinghouse Electric Corporation in *Sales Management*, September 18, 1959, p. 17.



others, leisure-time marketers (including sellers of services) have adopted credit plans to accelerate the expansion of their markets. For instance, "go now—pay later" travel plans have made international air travel possible for the average man. It is interesting that the rate of default on payments under the air travel credit plans has been under one-fifth of one per cent—far below the average for other instalment purchases.<sup>9</sup> The changed attitude toward debt, then, has resulted in increasing competition for the consumer's dollar among the sellers of all types of goods and services.

A third change in American society is commonly referred to as the "white collar revolution." In 1900, only about 15 per cent of all male jobs were white collar ones. In 1940, this proportion had risen to 25 per cent and will become an estimated 40 per cent by 1970.<sup>10</sup> Increasing emphasis on research of all kinds has increased the need for technically trained white collar workers to perform the research. Also, such technological advances as the use of automated machinery in factories, the increasing use of materials handling equipment in factories and in warehouses, and the growth of self-service retailing, have all reduced the number of blue collar jobs while increasing the demand for white collar workers to operate the equipment and keep records. There are still blue collar strongholds, mainly in factories and on farms, but even here there are more and more skilled workers and fewer and fewer unskilled workers. So the "white collar revolution" really involves both white collar and blue collar workers—there has been a general upgrading of jobs and incomes. This upgrading has brought about a steady growth in the number of Americans who can afford at least some of the amenities once associated only with the highest positions in our society. Differences among classes are coming to be based not so much on income as on "taste." A sociologist, Nelson Foote, predicts that in the future people will be "classed" mainly in terms of their leisure pursuits—in such activities as travel, theatergoing, gardening, crafts, participation in public affairs, and voluntary associations.<sup>11</sup> But even taste itself is being upgraded, and it is becoming ever more difficult to distinguish between members of different classes when they are away from their jobs. A *Fortune* writer put it this way: "The change (in taste) will be pervasive, encompassing nearly all social and income groups, and will be evident not only in the things people buy, but in the ways people use

<sup>9</sup> W. G. Lipscomb, "Go Now—Pay Later: Time Payment for International Travel," *The Annals of the American Academy of Political and Social Science*, September, 1957, pp. 117-118.

<sup>10</sup> S. S. Parker and L. A. Mayer, "The Decade of the 'Discretionary' Dollar," *Fortune*, June 1959, p. 262.

<sup>11</sup> As quoted in G. Burek, "How American Taste is Changing," *Fortune*, July 1959, p. 193.

their leisure." <sup>12</sup> In the future, then, there should be significant expansions in the market for many products and services, which today are still limited to use by the highly sophisticated.

Other changes in American society are additional causes of market changes. There is, for example, the increasing interest in such participation sports as bowling; this has led to an increased demand for sporting goods of all kinds. The tendency toward a more informal style of living has caused a growing demand for sports clothes for both sexes and all age groups. More people have college educations and there are growing enrollments in adult education programs; both of these are resulting in changed tastes and increased changes in American society that are being watched by alert marketers of goods and services.

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<sup>12</sup> *Ibid.*, p. 115.

### CONCLUSION

Management philosophy increasingly reflects a new sense of appreciation for the importance of the market. This philosophy finds expression in the marketing concept under which an enterprise not only looks to its market for guidance but gears its entire operation toward serving that market. Marketing uncontrollables are continually changing and interacting in numerous and complex ways, and this causes markets to be ever-changing. In this chapter we have analyzed the marked changes that have been occurring in such uncontrollables as consumers' attitudes toward leisure and debt, the distribution and sources of consumers' income, and consumers' tastes. In succeeding chapters we will examine further marketing implications of changes in these and other uncontrollables.

### QUESTIONS AND PROBLEMS

1. If the marketing decision-maker has no control over the social, political, and economic environment in which he operates, and over the actions and reactions of individual consumers, why should he try to understand them?
2. Why do changes in the market normally start with the consumer and move backward through the channel of distribution to the producer? Is it not possible for the producer to initiate such changes?
3. Is it reasonable to generalize from history that marketing is important only in periods when there is a buyers' market and production in periods when there is a sellers' market?

4. As mass production and resulting mass markets remove the producer from close contact with his markets, the establishment of two-way communication becomes his primary problem. Please explain this statement.
5. Serving the needs of its customers (at a profit) is the primary reason for the existence of most businesses. Why, then, should the marketing concept appear to be a new discovery?
6. Would you say that regional differences in the population are more important to marketing than rural-urban-suburban differences? Why?
7. Would an increase in per capita income be more important to a food manufacturer or a clothing manufacturer? Explain.
8. With an increasing proportion of the population in the middle income market, we can expect increasing uniformity in consumer wants and needs. Do you agree with this statement? Why or why not?
9. Should a marketing man be more interested in the change in family income and purchasing power resulting from the increase in working wives or in the changes in wants and needs resulting from the wife's new contacts with the working world? Explain.
10. Give some examples of how the increase in leisure time has affected markets and marketing.
11. Why do you think most American families have changed their attitude toward debt and consumer credit?
12. Marketing men are interested in the increasing proportion of Americans to be found in the white collar and skilled labor groups because of its resulting increase in disposable income, but is this the only result that should interest marketers? Discuss.
13. Are changes in the level of education of any real importance to marketing? Can you list five products for which the demand will be greater as education increases? And five for which the demand will decrease?
14. What are the changes in the American market that have made possible the successful development of planned shopping centers at the expense of downtown retailing?

# ECONOMIC DETERMINANTS OF DEMAND

## 7

Viewed in terms of economics, demand is affected by two groups of factors: (1) those such as advertising, personal selling, product innovation and improvement, and price, over which the individual firm, to a greater or lesser extent, can exert some influence, and (2) those which are largely outside the influence of the individual firm, e.g., total monetary income and the way it is distributed among consumers and other spending units. In this chapter, we will focus mainly on the uncontrollable determinants which, although largely beyond the control of the individual firm, are nevertheless important to it. This is because they must be considered in planning and budget-

ing the application of the controllable economic determinants. A marketing executive may not be able to manipulate the uncontrollable determinants, but he must consider them when manipulating the controllable determinants. The forecast of future sales, for example, is an essential part of marketing planning, but it can be neither realistic nor complete if it ignores the uncontrollable economic determinants of market demand.

### SORTING THEORY AND EXPLAINING CONSUMER BUYING BEHAVIOR

In attempting to build marketing theory out of economic theory, we must discard one assumption that pervades much of economics—that markets are homogeneous. Heterogeneity, not homogeneity, characterizes markets. Furthermore, this heterogeneity is evident on both the supply and demand sides of every market. Marketing, considered as an economic process, has the goal of matching heterogeneous segments of supply with heterogeneous segments of demand. This goal is achieved through the marketing mechanism known as “sorting.”

Alderson<sup>1</sup> contends that the whole economic process starts with conglomerations and ends with assortments. A conglomeration contains two or more types of goods but they have not been brought together for the purpose of serving the needs of a particular individual or group. An assortment is also a collection of two or more types of goods, but unlike a conglomeration, the goods in an assortment either complement each other directly or are jointly capable of serving the needs of a particular individual or group.<sup>2</sup> The intermediate phases in moving goods from a heterogeneous supply segment to a heterogeneous demand segment consist of the four types of sorting and it is with these types of sorting that much of marketing is concerned. Alderson describes them as follows: <sup>3</sup>

Starting with a conglomeration, we can perform the operation of *sorting out*, which breaks the collection into various types of goods. Sorting out results in a set of separate supplies which may be regarded as homogeneous in terms of the classification being used by the sorter. Given small homogeneous supplies, it is possible to create larger supplies by adding one to another. This building-up of a larger supply may represent the *accumulation* over a period of time from a single sorting operation, or it may represent the bringing together in a single place products which meet standard

<sup>1</sup> The ideas which form the basic substance of this section are contained in the writings of Wroe Alderson, a distinguished management consultant, who has been a major contributor to the development of marketing theory. See: W. Alderson, *Marketing Behavior and Executive Action* (Homewood, Ill.: Richard D. Irwin, 1957), especially Chapter VII. Also see: W. Alderson, “The Analytical Framework for Marketing,” in D. J. Duncan (Ed.), *Proceedings of the Conference of Marketing Teachers from Far Western States* (Berkeley: University of California, 1958), pp. 15-28.

<sup>2</sup> Alderson, *Marketing Behavior and Executive Action*, op. cit., pp. 199-200.

<sup>3</sup> *Ibid.*, p. 201.

specifications but are drawn from different localities. . . . Once a large homogeneous supply has been accumulated, it may . . . be broken down by a process of apportionment or *allocation*. Division of the total supply is made in terms of the requirements of various operating units whose claims are to be met. Allocation may take place within a single organization in terms of planning and control, or it may take place through the market and be determined by such a consideration as price. Finally, there is the step of using supplies to build up assortments. This process may be designated as *assorting*, or the putting together of unlike supplies in accordance with some pattern determined by demand.

During the process of marketing, all these types of sorting are used in matching supply with demand. Whereas economic theory has emphasized scarcity rather than the unique character of consumer's needs, and has paid most attention to the allocation phase of sorting, marketing theory places the emphasis on *assorting* as the final sorting step required in meeting the needs of consumers. In other words, marketing theory attempts to explain consumer buying behavior in terms of what consumers are trying to do. Essentially, consumers are engaged in building assortments, in replenishing or extending inventories of goods for use by themselves and their families. This, according to Alderson, means that the consumer buyer enters the market as a problem-solver. Solving a problem, either on behalf of a household or on behalf of a marketing organization, means reaching a decision in the face of uncertainty. In the double search which pervades marketing, the consumer buyer and the marketing executive are opposite numbers. The consumer buyer looks for goods in order to complete an assortment, while the marketing executive looks for buyers who need his goods.<sup>4</sup>

This viewpoint is consistent with those economic theories which explain competition among sellers by emphasizing innovative competition, product differentiation and differential advantage. The position occupied by every firm engaged in marketing is in some respects unique. Each firm is differentiated from all others by the characteristics of its products, its services, its geographic location, or its particular combination of these features. Therefore, the survival of each firm requires that it present, to some group of buyers, a differential advantage over all other suppliers. Any marketing organization makes sales to a core market composed of buyers who prefer this source, and to a fringe market made up of buyers who find the source acceptable, at least for occasional purchases.<sup>5</sup>

#### THE "INCOME-EXPENDITURES" MODEL

Of the many factors affecting the strength of market demand, income is by far the most powerful. Purchasing power in the hands of consumers

<sup>4</sup> Alderson, "The Analytical Framework of Marketing," *op. cit.*, pp. 17-18.

<sup>5</sup> *Ibid.*, p. 18.

and other spending units, most of it current income, is a basic ingredient of the economic process. Products may be produced and consumers may "want" to buy them, but no exchange takes place unless there is purchasing power in the form of money (or some money substitute such as credit) with which to complete purchase-sale transactions. It is appropriate, then, for us to consider the way in which purchasing power is generated. Economists have developed various "models" in their attempts to explain this process.<sup>6</sup>

For some years, economists have held that total spending depends on the "circular" flow of income. Consumers spend their incomes to buy products from businesses, and businesses pay their employees, who are also consumers, for providing services. Furthermore, businesses buy from and sell to each other, and every such transaction involves the exchange of products and/or services by one side in return for money from the other side. In every purchase-sale transaction, the buyer looks upon the transaction as requiring spending, while the seller looks upon it as providing sales revenue, i.e., income. Thus, the flow of income is from businesses to employee consumers, from consumers to businesses, and from businesses to businesses. If such intermediaries as wholesalers and retailers are disregarded, it is easy to see that John Jones gets the money to buy a room air conditioner by working at a steel mill. The steel mill gets the money to pay John Jones by selling steel to the manufacturer of room air conditioners. The manufacturer of room air conditioners gets the money to pay for the steel by selling room air conditioners to John Jones and other consumers.

The above explanation of the income-expenditures relationship is greatly oversimplified. Simplified models are usually the easiest to understand, but complex models are often more realistic. In order to make the income-expenditures model more realistic, then, it is necessary to introduce additional complications. Therefore, other features are introduced as the model is examined more closely later on in this chapter.

#### *Some Necessary Definitions*

In order to understand the income-expenditures model, it is necessary first to know the meanings of certain terms.<sup>7</sup> These terms, which can be thought of as essential components of the model, bear definite mathematical relationships to each other. Exhibit 7.1, which contains certain data on income

7.1

Relationship of Various Income  
Concepts, Personal Saving, and Personal Consumption  
Spending in the United States, 1961. (Billions of Dollars)

Gross National Product		518.7
— Capital Consumption Allowances	45.3	
— Indirect business taxes, business transfer payments, other adjustments	45.6	—90.9
= National Income		427.8
— Corporate Profits, inventory valuation adjustments, contributions for social insurance, other adjustments	67.2	
+ Dividends, net interest paid by government, government and business transfer payments	55.8	—11.4
= Personal Income		416.4
— Personal Taxes		—52.8
= Disposable Personal Income		363.6
— Personal Saving		—25.6
= Personal Consumption Spending		338.1

Source: *Survey of Current Business*, July 1962, pp. 6-8.

and consumption in the United States for 1961, shows these relationships. The necessary definitions are as follows:

**GROSS NATIONAL PRODUCT.** This is the familiar "g.n.p." which is so widely used as an indicator of general economic activity. *Gross national product is the nation's total production of goods and services (usually for a year), valued in terms of the market prices of the goods and services rendered.* G.n.p. is computed to include all the goods and services produced whether they have been sold or not. Those which have been produced but not sold are counted as being bought by the producers holding them. In addition, double-counting is avoided by counting raw materials and component parts only once—in the value of the final product. Goods in intermediate processing stages at the date of counting are considered investments in inventories by those holding them in the stage they have reached. This method of calculating g.n.p. is shown in the left half of Exhibit 7.2. Because of the way it is defined, *gross national product may also be calculated by adding together the nation's total spending on goods and services produced during the year.* This alternate computation is shown in the right half of Exhibit 7.2.



**Exhibit 7.2**  
**Two Different Methods of Computing Gross National Product in the United States for 1961. (Billions of Dollars)**

Compensation of employees	302.2	Personal consumption spending (Consumers' Goods and Services)	338.1
+ Income of unincorporated business	47.8		
+ Rental income of persons	12.3	+ Gross private domestic investment (Industrial goods, changes in business inventories, residential construction)	69.3
+ Corporate profits and inventory valuation adjustment	45.5	+ Net exports of goods and services (Exports minus imports)	3.9
+ Net Interest	20.0	+ Government purchases of goods and services (National defense and other purchases less governmental sales)	107.4
= National Income	427.8		
+ Capital Consumption Allowances	45.3		
+ Indirect business taxes, business transfer payments, other adjustments	45.6		
= Gross National Product	518.7	= Gross National Product	518.7

Source: *Survey of Current Business*, July 1962, p. 10.

**NATIONAL INCOME.** *National income is the total of all income earned by the "factors of production"—land, labor, capital, and management. As shown in Exhibit 7.1, national income is computed by deducting two major items from the g.n.p. figure. These deductions are capital consumption allowances (called "depreciation" by businessmen) and indirect business taxes, business transfer payments, and other adjustments.<sup>8</sup> The method of calculation used eliminates the possibility of double-counting. In arriving at the national income total, only the profit of each business is included as its income. The remainder of each firm's gross sales income is paid out in wages and other costs and thus is reflected as income of individuals and other businesses. An alternate method for calculating national income, that is, by adding together the different types of income payments, is shown in the left half of Exhibit 7.2.*

**PERSONAL INCOME.** *Personal income is total income received by all individuals in the country—what individuals actually have to spend, save, and pay taxes with. Personal income is calculated by deducting from national income those parts which do not represent actual income paid to individuals. In this calculation, corporations are not considered individuals. Therefore, corporation profits and social security taxes paid by businesses are first deducted from national income. Payments made by individuals to the government for such future benefits as social security, which cannot be considered current income to individuals, are also deducted. Then, certain other items are added back in, including dividends paid by corporations to individuals and transfer payments made by government to individuals (social security payments, welfare payments, interest on government bonds held by individuals, and so on).*

**DISPOSABLE PERSONAL INCOME.** *Disposable personal income is what people have left to spend or save after they have paid their taxes. Total disposable personal income is what the whole population has available for spending for personal consumption. It represents payments received by individuals from all sources other than personal gifts, which are excluded because there is no way of calculating them. Of all the national income concepts, disposable personal income is the most appropriate one to use in connection with analyses of variations in the demand for different consumers' goods.*

#### ***Factors Affecting Personal Consumption Spending***

**DISPOSABLE PERSONAL INCOME.** Goods and services are produced for purposes of consumption; purchasing power is used to convert production into

<sup>8</sup> For complete explanations of the various computations and deductions involved in calculating g.n.p., national income, and related concepts, see Bach, *op. cit.*, pp. 59-62.

consumption; and disposable personal income represents potential purchasing power in the hands of consumers. Therefore, there is a relationship between total disposable personal income and total personal consumption spending. Economists have made many studies of this relationship which they call the "consumption function."<sup>9</sup> Figure 7.1 shows this relationship for the United States for the years 1929 through 1958. Disposable personal income is plotted along the horizontal axis and personal consumption spending along the vertical axis. If all disposable personal income were used for personal consumption spending, the line of average relationship shown would exactly bisect into two 45-degree angles the right angle at the lower left of the figure. However, if the lower end of the line of average relationship, as drawn, were extended to the left, it would cut through the vertical axis (personal consumption spending) at a point above the horizontal axis (disposable personal income). This would imply that purchasing power (from sources other than current income) would be used for personal consumption even if disposable personal income were to dry up completely. Fortunately, this has never happened but, in 1933, during the great depression, personal consumption spending (\$46 billion) actually did exceed disposable personal income (\$45 billion). It was possible for people to spend more than they received because they both dipped into their savings and bought goods by pledging future income (i.e., by buying on credit). Notice that a similar situation occurred in 1932. In 1934, virtually all disposable personal income (\$52 billion) was used for personal consumption spending (\$51.9 billion).

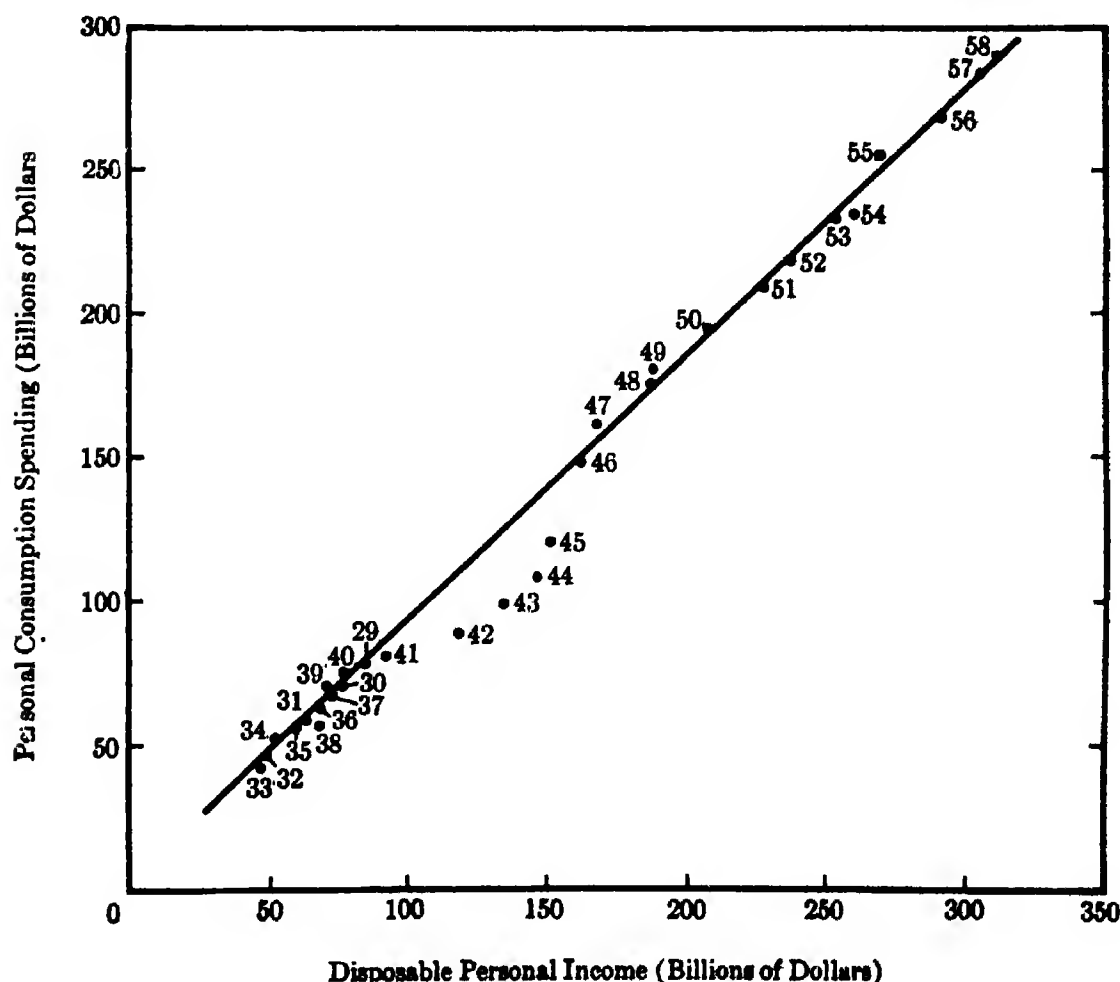
In most years, however, people do not spend all of their income. Normally, disposable personal income exceeds personal consumption spending. Disposable personal income is used both for personal consumption spending and for saving. That is why, as shown in Figure 7.1, the line depicting the average relationship of disposable personal income and personal consumption spending shows income exceeding spending. The fact that most years fall on or near the line shows that the relationship is "normally" quite stable. However, it should be noted that in some years the stable relationship did not hold. During World War II (1942-1945) for example, personal consumption spending was much lower than would normally have been expected considering the high incomes received. During these years, there were numerous shortages of consumers' goods (arising from the diversion of production capacity to wartime uses) accompanied by govern-

<sup>9</sup> For example, see: M. Friedman, *A Theory of the Consumption Function* (Princeton, N.J.: Princeton University Press, 1957). For some comments on the theory expounded by Professor Friedman, see those of J. Tobin, T. Morgan, I. Friend, and G. H. Orcutt in: L. H. Clark (Ed.), *Consumer Behavior* (New York: Harper & Brothers, 1958), pp. 447-462.

ment rationing, and patriotic appeals to consume less and save more. Consequently, there was "pent-up" demand after the war, in 1947 through 1949, and personal consumption spending was higher than normal.

**PROPENSITIES TO CONSUME AND TO SAVE.** The line of average relationship in Figure 7.1, which we have called the "consumption function," is also known as the *average propensity to consume*. If disposable personal income in some year comes to \$300 billion and personal consumption spending is \$275 billion, the average propensity to consume would be  $275 \div 300$ , or roughly 92 per cent. Therefore, in this year, on the average, people would spend about \$92 out of every \$100 of income received. They would save, on the average, the remaining \$8. The *average propensity to save* would be 8 per cent. The average propensities to consume and to save indicate the divisions which consumers normally make of their total disposable incomes. They do not indicate, unless average propensities remain

Figure 7.1



Source: *Survey of Current Business*, July 1959, pp. 10-11.

unchanged, what changes in spending and saving to expect if total incomes should rise or fall. Sometimes average propensities do not change with changes in income, but they usually do.

In order to facilitate analysis of the way people allocate changes in their total incomes between spending and saving, economists have developed two additional concepts—the *marginal propensity to consume* and the *marginal propensity to save*. If disposable personal income should rise from \$300 billion to \$310 billion, businessmen would be interested in learning what proportion of the additional \$10 billion consumers might decide to spend and what proportion they might decide to save. Suppose that out of the \$10 billion of “marginal” income consumers spend \$9 billion and save \$1 billion. The proportion spent ( $9 \div 10$ ), or 90 per cent, is called the *marginal propensity to consume*. The proportion saved ( $1 \div 10$ ), or 10 per cent, is known as the *marginal propensity to save*. Occasionally the average and marginal propensities to consume and save are identical, but usually they are not.

Business analysts, including marketing analysts, are usually more interested in examining the effect of changes in income on spending and saving than they are in the average relationships. The reason why is not difficult to understand. Consider what happens to personal consumption spending with a change in income. The percentage of disposable personal income used for personal consumption spending declined from 93.6 per cent in 1955 to 92.2 per cent in 1956, a drop of 1.4 per cent. In other words, the average propensities to consume and save changed very little. From 1955 to 1956, disposable personal income rose from \$274.5 billion to \$292.9 billion, while personal consumption spending rose from \$256.9 billion to \$269.9 billion. There was, then, an \$18.4 billion increase in income and a \$13 billion increase in consumer spending. Dividing the change in spending by the change in income ( $13 \div 18.4$ ), the marginal propensity to consume was only 70.65 per cent. *Personal consumption spending tends both to rise and fall at a slower rate than does disposable personal income*. In years of lower income, a higher proportion of income is spent and a lower proportion is saved. In years of higher income, the proportion spent tends to decline and that saved rises. The marginal propensity to consume and to save concepts take into account the rates of change. The average propensity to consume and to save concepts do not. This explains why analysts consider the two marginal concepts so valuable.

SIZE OF FAMILY, SIZE OF FAMILY INCOME, AND CHANGES IN FAMILY INCOME. Size of family income and size of family obviously affect patterns of spending and saving but, unfortunately, little published information is available to illustrate the nature of these relationships and patterns. However, one study of urban families made in 1950 disclosed that for dispos-

able personal incomes under \$4,000, average personal consumption spending exceeded income. The same study showed that the average propensity to consume tended to decline rather rapidly as income rose above the \$4,000 level.<sup>10</sup> In a more recent study, *The Life Study of Consumer Expenditures* (on which Exhibit 7.3 is based), households were classified according to annual household income *before taxes* rather than according

**Exhibit 7.3**  
Average Annual Household Spending by Level  
of Annual Household Income: United States—1956

<i>Annual Household Income (Before taxes)</i>	<i>Number of U.S. Households</i>	<i>Average Annual Household Spending</i>	<i>Average Persons Per Household</i>	<i>Per Cent of U.S. Households</i>	<i>Per Cent of Total Spending</i>
Under \$2,000	8,610,000	\$1,933	2.7	18%	9%
\$2,000-\$2,999	7,080,000	2,924	3.2	14	10
\$3,000-\$3,999	7,510,000	3,839	3.4	15	14
\$4,000-\$4,999	9,250,000	4,363	3.4	19	20
\$5,000-\$6,999	9,680,000	5,016	3.6	20	24
\$7,000-\$9,999	4,680,000	6,063	3.7	9	14
\$10,000 or more	2,330,000	7,946	3.8	5	9
All Households	49,140,000	\$4,110	3.3	100%	100%

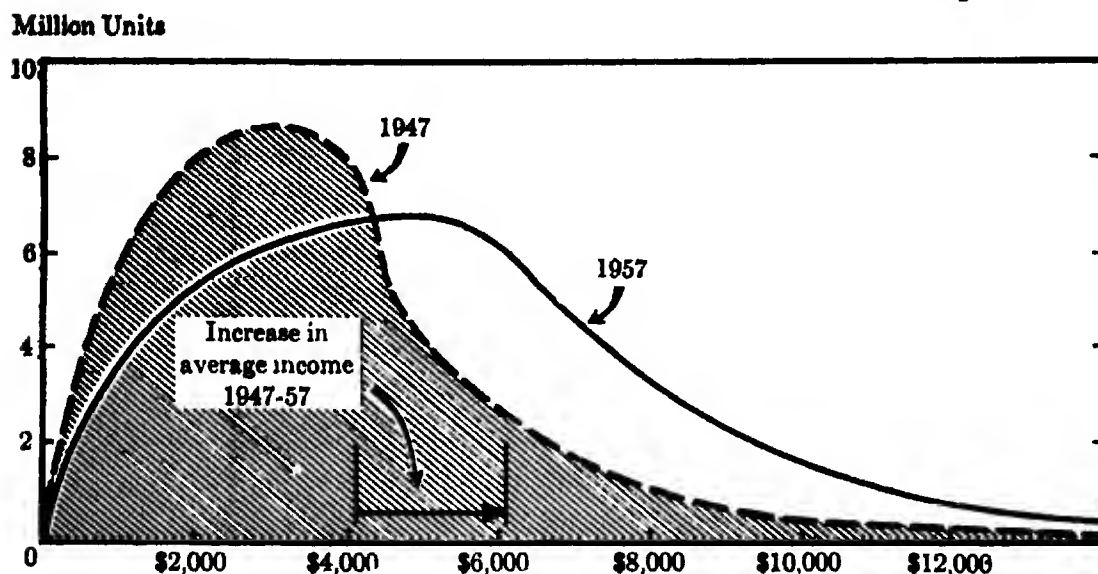
Source: Adapted from *The Life Study of Consumer Expenditures*, 1957, Vol. 1, pp. 18-21.

to the amount of disposable personal income. However, even though disposable personal income was not the income concept used in making this study, the results shown in Exhibit 7.3 do furnish some basis for generalizing. Just as total personal consumption spending tends to rise with increases in total disposable personal income, average annual household spending also rises with increases in gross income per household. And, contrary to what is commonly assumed, the number of people in the household appears to be directly related to the size of annual household income. As the average number of people in the household increases, annual household income rises. Moreover, the higher income brackets account for a disproportionately high share of total spending. According to the *Life Study*, the 47 per cent of U.S. households with gross annual incomes under \$4,000 account for only 33 per cent of total spending, whereas the 53 per cent with gross annual incomes over \$4,000 account for 67 per cent of total spending.

<sup>10</sup> See: *Study of Consumer Expenditures, Incomes, and Savings* (Philadelphia: Wharton School of Finance and Commerce, University of Pennsylvania, 1956), Vol. XVIII.

Data such as those in Exhibit 7.3 are very important to the marketing analyst because they imply that significant changes occur in the spending and saving patterns of a family as it moves from one income bracket to another and that changes in the distribution of U.S. families relative to income brackets may bring about important changes in propensities to consume and to save.

Figure 7.2



U.S. Department of Commerce, Office of Business Economics

Source: S. F. Goldsmith, "Size Distribution of Family Income," *Survey of Current Business*, April 1958, p. 13

As indicated in Figure 7.2, there has been a broad shift of the income distribution curve from the range below \$4,000 of before-tax average income on the left-hand side of the diagram, to the higher income bands on the right-hand side. The number of families with incomes over \$4,000 before taxes more than doubled between 1947 and 1957. Of particular interest is the shift of the peak of the curve, which represents the modal, or most common, family income. This modal range moved from the \$3,000—\$3,500 income bracket in 1947 to the \$4,500—\$5,000 bracket in 1957. Evidently, the rightward shift in the peak of this curve is continuing, for in 1960 the modal or most frequent income was estimated at \$4,820.<sup>11</sup>

**CONSUMERS' INCOME EXPECTATIONS.** The incomes which consumers expect to receive in the future have some bearing on their present spending patterns. Presumably, consumers' spending, particularly for automobiles,

<sup>11</sup> M. Liebenberg and J. M. Fitzwilliams, "Size Distribution of Personal Income, 1957-60," *Survey of Current Business*, May 1961, p. 11.

furniture, major appliances, and other durables, is influenced by their optimism or pessimism about future income. Although the results are not entirely conclusive, this hypothesis appears to have been borne out by the annual surveys made for the Federal Reserve Board by the Survey Research Center of the University of Michigan during the period 1946-1959. Exhibit 7.4 presents some preliminary findings of this survey for 1959 and the final results for 1948-1958. Notice that among the data included is "expected change in income rate." When this information is considered along with "plans to purchase" data (also shown in Exhibit 7.4), it appears that expectations of higher income have a direct effect on spending plans. The Survey Research Center has continued its *Annual Survey of Consumer Finances*, but now publishes and distributes the reports directly rather than through the Federal Reserve System. Each contains special tabulations and comparisons of variables influencing consumer behavior.

The Federal Reserve Board dropped its sponsorship of the Survey Research Center's annual survey in 1959 and initiated a *Quarterly Survey of Consumer Buying Intentions* conducted for it by the Bureau of the Census. FRB officials believed that the annual survey did not provide an adequate test of information on buying plans since shifts in plans during a year went undetected.<sup>12</sup> Sample pages from one of the quarterly surveys are reproduced in Exhibit 7.5 below. Notice that information is still reported on consumers' expected changes in income and their buying plans. The newer survey emphasizes a six-month consumer planning period, which the FRB considers more realistic as a planning horizon than a one-year period. The quarterly surveys also provide information on buying plans broken down by family income groups and by age of heads of households. In addition to presenting data on the timing of planned purchases, information on buying plans is reported in three ways—"definitely," "probably," and "maybe." Thus, this study takes into account the varying degrees of certainty of consumer buying plans.

A third source of information on consumers' income expectations and related data is the *Survey of Consumer Attitudes and Buying Plans* conducted on a "continuous" basis for the National Industrial Conference Board.<sup>13</sup> The stated purposes of the NICB survey are to identify "the expectational determinants of consumer spending and saving" and to improve "methods of analysis of consumer behavior."<sup>14</sup> Among other items included in this survey are "current household income compared with

<sup>12</sup> "Quarterly Survey of Consumer Buying Intentions," *Federal Reserve Bulletin*, September 1960, p. 977.

<sup>13</sup> For a description of the design and conduct of this study, see *The Conference Board Business Record*, Vol. XV, No. 11 (November 1958).

<sup>14</sup> *The Conference Board Business Record*, Vol. XIX, No. 5 (May 1962), p. 8.



**Exhibit 7.4**  
**Preliminary Results of the Federal Reserve Survey of  
 Consumer Finances Early 1959, with Final Results for 1948-58**

[Percentage distribution of spending units]

<i>Consumer plans and expectations</i>	1959	1958	1957	1956	1955	1954	1953	1952	1951	1950	1949	1948
	<i>Expected change in income rate</i>											
Making more a year from now	42	37	40	37	39	29	34	37	28	27	28	28
No change	35	34	35	36	36	35	33	30	32	46	47	47
Making less a year from now	7	11	7	8	6	15	10	8	10	17	13	13
Uncertain, not ascertained	16	18	18	19	19	21	23	25	30	10	12	12
All cases	100	100	100	100	100	100	100	100	100	100	100	100
	<i>Expected general business conditions</i>											
Good times	55	31	60	64	59	43			40	47	47	47
Fair times	8	9	7	5	5	8			15	14	6	6
Bad times	17	41	13	9	12	25			17	25	26	26
Uncertain, not ascertained	20	19	20	22	24	24			28	14	21	21
All cases	100	100	100	100	100	100			100	100	100	100

*Expected price movements for consumer goods*

Increase during year	61	48	15	17	53	77	15	8	33
No change	26	29	40	43	30	16	36	20	24
Decrease during year	6	13	37	31	7	3	41	55	28
Uncertain, not ascertained	7	10	8	9	10	4	8	17	15
All cases	100	100	100	100	100	100	100	100	100

*Plans to purchase*

Houses	9.3	7.5	8.7	9.4	6.6	8.8	6.4	8.5	8.4	7.0	7.5
Home improvement and maintenance	24.6	22.1	23.4	22.2	19.6	16.9					
New automobiles	7.6	6.9	8.5	8.4	7.9	9.0	6.8	6.6	10.6	11.8	9.7
Used automobiles	9.8	10.4	8.4	7.2	6.4	6.2	6.0	5.5	6.9	6.8	4.1
Furniture and major household appliances	27.8	28.2	29.4	28.5	26.9	31.9	23.2	27.4	28.4	30.9	27.4

*Median planned expenditure*

New automobile	\$3,030	\$2,840	\$2,920	\$2,810	\$2,900	\$2,570	\$2,500	\$2,340	\$1,970	\$1,920	\$1,980	\$1,800
Used automobile	860	910	890	800	810	750	950	760	590	540	630	600
Furniture and major household appliances	280	290	300	290	290	330	330	300	300	290	250	240
Home improvement and maintenance	360	380	450	370	330	300						

Sources: *Federal Reserve Bulletin*, March 1959, p. 253.

Table 1: Plans to Buy Houses and Durable Goods, 1960-62<sup>1</sup>

Buying plan	1960				1961				1962			
	Jan.	Apr.	July	Oct.	Jan.	Apr.	July	Oct.	Jan.	Apr.	July	Oct.
Percentage of all families												
New or used automobile: 2												
Planning to buy within 12 months	18.7	17.1	16.8	18.6	17.9	16.6	17.4	18.5	18.1	18.9		
Doesn't know about 12-month plan	7.8	7.5	7.1	7.1	7.4	7.6	7.3	8.0	7.7	7.9		
Planning to buy within 6 months	9.5	8.8	8.1	9.1	9.0	8.4	8.4	9.1	9.1	10.2		
Doesn't know about 6-month plan	3.6	3.0	2.8	2.8	2.7	2.9	2.9	3.1	3.0	3.3		
Has shopped for automobile 3	4.5	5.5	4.9	6.3	4.5	5.1	4.6	5.0	4.3	5.4		
Dissatisfied with automobile owned	9.8	8.7	8.0	9.6	10.0	8.9	9.1	9.2	10.3	9.8		
New automobile:												
Planning to buy within 12 months	7.4	7.0	6.9	7.9	7.4	6.8	7.6	8.1	7.8	7.7		
Planning to buy within 6 months	3.5	3.3	3.1	3.7	3.5	3.1	3.4	3.7	3.7	3.4		
Degree of certainty:												
Definitely	1.3	1.5	1.2	1.5	1.4	1.1	1.4	1.6	1.5	1.5		
Probably	1.0	.9	1.0	1.2	1.1	1.1	1.1	1.2	1.2	1.0		
Maybe	1.1	.8	.8	.9	1.0	.9	1.0	.9	1.0	1.0		
Timing of planned purchase:												
First 3 months	.9	1.2	.9	1.3	1.0	.9	1.1	1.4	1.1	1.3		
Second 3 months	1.7	1.3	1.4	1.4	1.6	1.4	1.5	1.5	1.7	1.3		
Doesn't know when in 6 months	.8	.7	.7	.9	.9	.8	.8	.8	.9	.8		
Used automobile:												
Planning to buy within 12 months	8.4	7.2	7.2	8.0	8.3	7.7	7.9	8.2	8.3	9.2		
Planning to buy within 6 months	4.6	3.9	3.8	4.0	4.5	4.1	4.2	4.4	4.3	5.6		
Degree of certainty:												
Definitely	1.6	1.3	1.4	1.2	1.5	1.6	1.5	1.4	1.5	2.0		
Probably	1.5	1.2	1.2	1.3	1.4	1.3	1.2	1.5	1.4	1.8		
Maybe	1.5	1.3	1.2	1.4	1.6	1.3	1.5	1.5	1.4	1.8		
Timing of planned purchase:												
First 3 months	1.3	1.4	1.4	1.3	1.3	1.7	1.6	1.4	1.3	2.1		
Second 3 months	2.0	1.3	1.2	1.7	2.0	1.3	1.6	1.7	1.8	1.9		
Doesn't know when in 6 months	1.2	1.1	1.1	.9	1.2	1.1	1.0	1.3	1.2	1.6		

House (new or existing):	12.0	11.1	11.2	10.6	10.3	10.0	10.0	10.6	9.8	10.0
Planning to buy within 24 months	6.6	6.2	6.6	6.8	6.4	6.3	6.1	6.4	6.1	6.4
Doesn't know about 24-month plan	5.8	5.3	5.4	5.0	4.8	5.1	5.0	5.1	4.8	5.2
Planning to buy within 12 months										
Degree of certainty:										
Definitely	2.3	2.2	2.2	2.0	1.9	2.1	2.0	2.2	1.7	2.0
Probably	1.8	1.6	1.6	1.5	1.5	1.5	1.6	1.6	1.5	1.5
Maybe	1.7	1.5	1.5	1.5	1.4	1.4	1.4	1.3	1.6	1.7
Timing of planned purchase:										
First 6 months	2.4	2.5	2.4	1.9	1.9	2.3	1.9	2.0	1.8	2.3
Second 6 months	1.8	1.3	1.7	1.9	1.5	1.4	1.7	1.8	1.5	1.3
Doesn't know when in 12 months	1.6	1.4	1.3	1.1	1.4	1.3	1.4	1.3	1.5	1.6
Doesn't know about 12-month plan	2.4	2.4	2.4	2.5	2.1	2.2	2.2	2.3	2.0	2.3
Plans per 100 families										
Household durable goods: <sup>4</sup>	24.3	21.9	20.1	21.0	20.5	20.2	18.4	19.6	18.8	20.1
Planning to buy within 6 months										
Degree of certainty:										
Definitely	7.5	7.7	6.5	7.4	6.3	6.5	6.2	7.0	6.5	7.1
Probably	6.0	5.8	5.0	5.5	5.4	5.6	4.8	5.0	5.1	5.2
Maybe	10.7	8.5	8.6	8.1	8.8	8.1	7.3	7.6	7.2	7.9
Timing of planned purchase:										
First 3 months	5.4	7.4	5.9	6.8	5.1	6.7	5.8	6.9	4.8	7.2
Second 3 months	10.6	7.7	7.4	8.2	8.8	7.8	7.4	7.1	8.8	7.1
Doesn't know when in 6 months	8.2	6.7	6.7	6.0	6.6	5.7	5.2	5.6	5.2	5.8
Doesn't know about 6-month plan	5.5	5.4	4.7	4.5	4.7	5.0	4.6	4.6	5.2	5.1
Major household durable goods: <sup>5</sup>										
Planning to buy within 6 months	15.7	13.9	14.0	13.8	13.7	13.0	12.8	13.1	12.2	13.0
Degree of certainty:										
Definitely	4.7	4.7	4.4	4.7	4.1	4.1	4.1	4.5	4.1	4.4
Probably	3.3	3.1	3.0	3.1	3.0	3.1	3.1	2.8	2.8	3.0
Maybe	7.7	6.2	6.7	5.9	6.6	5.8	5.6	5.9	5.3	5.7
Timing of planned purchase:										
First 3 months	3.7	3.8	3.8	4.2	3.5	3.7	3.9	4.5	3.2	4.0
Second 3 months	5.8	4.9	4.7	5.1	5.1	5.0	4.7	4.3	5.0	4.5
Doesn't know when in 6 months	6.1	5.2	5.4	4.5	5.1	4.2	4.2	4.3	4.0	4.5
Doesn't know about 6-month plan	2.8	2.7	2.9	2.6	2.9	2.8	2.9	2.9	2.9	3.0

<sup>1</sup> As reported in interviews in the first month of each calendar quarter. Interviews are taken in the week that includes the 19th of the month.

<sup>2</sup> Planning period begins on the date of interview.

<sup>3</sup> Includes those undecided between new and used.

<sup>4</sup> In the weeks immediately preceding interview.

<sup>5</sup> Sum of plans to buy washing machines, refrigerators, television sets, air conditioners, clothes dryers, radio and phonographic equipment, and dishwashers.

<sup>6</sup> Sum of plans to buy first three items listed in note 4.

Table 2: Plans to Buy Houses and Durable Goods within Income and Age Groups, 1980-82

Planning period, and income or age group	1980				1981				1982			
	Jan.	Apr.	July	Oct.	Jan.	Apr.	July	Oct.	Jan.	Apr.	July	Oct.
Planners as a percentage of all families in group												
Planning to buy new automobile within												
6 months:												
All families	3.5	3.3	3.1	3.7	3.5	3.1	3.4	3.7	3.7	3.7	3.7	3.4
Income: 1												
Under \$3,000	7	9	8	6	6	8	7	7	9	9	9	9
\$3,000-\$4,999	2.3	1.7	1.5	2.4	1.9	1.7	2.2	2.3	2.0	2.0	2.0	1.8
\$5,000-\$7,499	4.0	4.5	3.6	4.5	4.1	3.8	3.8	3.4	3.8	3.8	3.5	3.5
\$7,500-\$9,999	6.8	5.5	6.6	6.8	6.3	4.8	6.0	6.7	6.3	6.3	6.2	6.2
\$10,000 and over	12.0	9.6	9.9	11.7	11.3	9.6	11.0	13.4	11.5	11.5	9.4	9.4
Age of head:												
Under 35	3.2	3.3	3.4	3.7	3.6	3.2	3.3	3.4	4.1	4.1	3.4	3.4
35-54	4.5	4.1	3.7	4.4	4.3	3.7	4.3	4.6	4.1	4.1	4.0	4.0
55 and over	2.5	2.3	2.1	2.9	2.5	2.4	2.3	2.7	2.9	2.9	2.8	2.8
Planning to buy used automobile within												
6 months:												
All families	4.6	3.9	3.8	4.0	4.5	4.1	4.2	4.4	4.3	4.3	5.6	5.6
Income: 1												
Under \$3,000	3.1	2.6	2.9	2.9	2.8	2.5	2.7	3.0	2.3	2.3	4.0	4.0
\$3,000-\$4,999	4.8	4.3	4.1	4.4	4.9	5.1	4.5	4.7	5.3	5.3	5.8	5.8
\$5,000-\$7,499	6.0	4.9	4.6	4.9	6.0	4.6	5.3	5.7	6.1	6.1	6.7	6.7
\$7,500-\$9,999	6.3	4.8	5.4	5.6	4.9	5.4	5.2	5.5	3.9	3.9	7.0	7.0
\$10,000 and over	5.5	3.3	4.1	3.9	4.8	4.3	4.7	4.1	4.8	4.8	5.4	5.4
Age of head:												
Under 35	6.5	6.8	6.6	6.7	7.1	6.8	7.1	7.0	7.4	7.4	9.9	9.9
35-54	5.5	4.3	4.0	4.3	5.0	4.8	4.7	4.8	4.6	4.6	6.2	6.2
55 and over	2.1	1.4	1.5	1.6	2.0	1.5	1.6	2.1	1.8	1.8	2.0	2.0
Planning to buy house within 12 months:												
All families	5.8	5.3	5.4	5.0	4.8	5.1	5.0	5.1	4.8	4.8	5.2	5.2
Income: 1												
Under \$3,000	1.9	1.7	2.1	1.8	1.5	1.7	2.2	2.4	1.7	1.7	2.3	2.3
\$3,000-\$4,999	5.3	5.1	5.4	4.9	4.1	4.8	4.8	4.6	4.7	4.7	4.5	4.5

\$5,000-\$7,499	8.4	7.1	7.3	7.0	6.6	6.4	6.7	6.1	6.2	6.6
\$7,500-\$9,999	9.1	8.4	8.6	8.4	7.3	7.9	7.9	7.8	6.4	7.4
\$10,000 and over	11.5	10.2	9.1	7.3	8.6	8.1	7.7	9.5	8.7	9.0
Age of head:										
Under 35	10.1	9.4	9.8	9.2	8.8	9.3	9.9	9.5	9.2	9.7
35-54	6.2	5.6	5.5	5.1	5.1	5.1	4.7	5.3	4.9	5.2
55 and over	2.4	2.0	2.2	2.0	1.7	2.1	2.1	2.0	1.6	2.3

#### Planning to buy household durable goods within 6 months: <sup>2</sup>

Plans per 100 families in group										
All families	24.3	21.9	20.1	21.0	20.5	20.2	18.4	19.6	18.8	20.1
Income: <sup>1</sup>										
Under \$3,000	13.4	12.1	11.1	10.8	10.0	10.4	10.7	10.9	10.0	11.7
\$3,000-\$4,999	21.1	19.3	18.8	19.6	15.0	15.9	14.8	16.5	16.4	17.0
\$5,000-\$7,499	26.1	24.0	24.1	24.9	24.7	21.4	20.5	21.1	21.4	22.0
\$7,500-\$9,999	39.9	30.8	29.8	32.2	31.5	28.6	28.4	30.2	26.9	26.8
\$10,000 and over	46.9	43.8	39.1	41.1	40.8	39.7	34.0	37.5	34.2	36.8
Age of head:										
Under 35	31.0	32.0	29.8	31.2	27.3	29.6	26.9	28.1	27.6	31.5
35-54	28.1	24.4	22.0	23.7	23.9	21.8	20.2	21.3	21.3	21.5
55 and over	14.9	11.9	11.2	10.6	11.8	12.0	10.4	11.8	9.7	11.0

#### Planning to buy major household durable goods within 6 months: <sup>2</sup>

All families	15.7	13.9	14.0	13.8	13.7	13.0	12.8	13.1	12.2	13.0
Income: <sup>1</sup>										
Under \$3,000	11.6	9.9	9.8	9.2	8.5	8.7	9.5	9.5	8.7	9.5
\$3,000-\$4,999	14.8	13.3	14.0	14.4	11.6	11.5	11.4	12.4	11.6	12.9
\$5,000-\$7,499	17.7	14.5	16.3	15.9	16.2	13.7	13.6	13.9	13.4	14.2
\$7,500-\$9,999	23.3	17.0	18.0	19.0	18.5	15.2	18.7	17.7	15.1	15.2
\$10,000 and over	23.9	21.4	22.4	21.4	23.1	21.5	19.2	20.2	17.8	18.9
Age of head:										
Under 35	18.7	19.8	19.5	19.7	17.5	18.3	17.8	18.3	17.2	19.2
35-54	17.8	15.0	15.3	15.3	15.5	13.7	14.0	14.0	13.5	13.8
55 and over	10.9	8.6	8.7	8.2	8.9	8.6	7.9	8.6	7.2	7.9

<sup>1</sup> Total money income before taxes of family in 12 months immediately preceding interview.

<sup>2</sup> Sum of plans to buy washing machines, refrigerators, television sets, air conditioners, clothes dryers, radio and phonographic equipment, and dishwashers.

<sup>3</sup> Sum of plans to buy first three items listed in note 2.

Table 3: Plans to Buy Specified Household Durable Goods within 6 Months, 1960-62  
[Percentage of all families]

Type of durable goods	1960				1961				1962	
	Jan.	Apr.	July	Oct.	Jan.	Apr.	July	Oct.	Jan.	Apr.
Washing machine	6.5	6.0	5.9	5.5	5.5	5.3	5.1	5.4	5.2	5.4
Refrigerator	4.5	3.8	4.0	3.4	3.7	3.6	3.4	3.3	3.1	3.4
Television set	4.6	4.1	4.0	4.9	4.4	4.1	4.2	4.5	3.9	4.2
Air conditioner	3.2	3.4	1.4	1.3	2.0	2.6	1.1	1.2	1.9	2.6
Clothes dryer	2.2	1.8	2.0	2.3	1.9	1.8	1.7	1.9	1.8	1.8
Radio and phonographic equipment <sup>1</sup>	2.3	1.9	1.9	2.7	2.1	2.1	2.1	2.5	2.3	1.9
Dishwasher	.9	.8	.8	.8	.8	.8	.7	.8	.6	.8

<sup>1</sup> Radios or phonographs (or their component parts) together costing \$100 or more.

Table 4: Purchasers of Houses and Specified Durable Goods, by Quarters, 1959-62 <sup>1</sup>  
[Percentage of all families]

Item	1959				1960				1961				1962	
	Oct.- Dec.	Jan.- Mar.	Apr.- June	July- Sept.	Oct.- Dec.	Jan.- Mar.	Apr.- June	July- Sept.	Oct.- Dec.	Jan.- Mar.	Apr.- June	July- Sept.	Oct.- Dec.	Jan.- Mar.
Automobile:														
New	2.4	2.7	3.2	2.8	2.8	2.8	2.2	2.2	2.8	2.1	2.2	2.2	2.9	2.3
Used	4.7	5.0	5.7	5.2	5.2	4.9	5.1	5.9	5.1	5.1	5.9	5.4	5.1	5.1
House (new or existing) <sup>2</sup>	1.5	.8	1.4	1.4	1.4	1.2	1.0	1.1	1.2	1.0	1.1	1.4	1.2	.9
Washing machine	3.2	2.4	2.7	2.8	2.8	2.9	2.2	2.5	2.8	2.2	2.5	2.8	2.8	2.3
Refrigerator	2.3	1.6	2.4	2.7	2.7	1.9	1.7	2.2	1.9	1.7	2.2	2.8	1.9	1.7
Television set	4.8	3.3	2.9	3.4	4.8	4.8	2.8	2.7	5.2	3.1	2.7	3.3	5.2	3.1
Air conditioner	.2	.3	1.1	1.0	.2	.2	.2	.8	.3	.2	.8	1.0	.3	.2
Clothes dryer	1.4	.6	.5	.7	1.1	1.1	.7	.4	1.0	.7	.4	.6	1.0	.7
Radio and phonographic equipment <sup>3</sup>	2.5	1.0	.9	1.0	2.9	2.9	.9	1.0	2.8	1.0	1.0	1.0	2.8	1.0
Dishwasher	.4	.3	.3	.3	.4	.4	.2	.3	.5	.2	.3	.3	.5	.2

<sup>1</sup> As reported in month immediately following purchase period.

<sup>2</sup> Estimates are subject to somewhat larger sampling errors than other data because of special problems involved in estimating purchases of new houses.

<sup>3</sup> Radios or phonographs (or their component parts) together costing \$100 or more.

Table 5: *Past and Expected Changes in Income, 1960-62*  
[Percentage distribution of families]

Direction of change	1960				1961				1962	
	Jan.	Apr.	July	Oct.	Jan.	Apr.	July	Oct.	Jan.	Apr.
Current income compared with a year earlier:										
Higher	25.0	22.2	21.5	23.2	22.6	20.7	20.6	22.6	22.2	23.1
Same	57.1	61.3	61.9	58.7	57.9	59.9	61.0	59.9	60.2	61.6
Lower	17.0	15.5	15.7	17.0	18.7	18.5	17.6	16.6	16.5	14.6
Doesn't know	.9	1.0	.9	1.1	.8	.8	.9	.9	1.0	.8
All families	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Expected income compared with current. <sup>1</sup>										
Higher	24.4	24.2	24.6	24.5	24.6	23.9	24.7	23.7	24.0	24.2
Same	59.6	60.2	59.6	59.2	57.2	59.4	58.5	59.3	60.0	60.3
Lower	5.7	5.6	5.9	5.8	6.0	5.4	5.8	5.7	5.0	5.1
Doesn't know	10.2	10.0	9.8	10.5	12.2	11.4	11.0	11.3	11.1	10.4
All families	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

<sup>1</sup> Expected a year hence.  
NOTE.—Details may not add to totals because of rounding.  
Source: *Federal Reserve Bulletin*, May 1962, pp. 538-540.





Savings accounts: <sup>2</sup>

Zero	50	78	68	66	54	52	46	35	29	27
\$1-\$199	13	4	7	9	16	19	19	17	16	7
\$200-\$499	7	4	5	6	5	8	8	12	10	8
\$500-\$999	8	5	6	5	6	6	10	12	10	8
\$1,000-\$1,999	7	4	5	4	8	5	8	10	12	7
\$2,000 and over	15	7	8	10	11	10	10	14	23	43
All cases	100	100	100	100	100	100	100	100	100	100

Checking accounts:

Zero	45	77	71	64	54	45	34	28	19	9
\$1-\$199	24	8	13	15	25	28	35	37	30	15
\$200-\$499	15	9	7	11	11	14	16	22	24	21
\$500-\$999	8	3	5	4	5	7	8	6	15	17
\$1,000-\$1,999	5	1	2	5	3	3	5	4	7	19
\$2,000 and over	4	2	2	2	2	3	2	4	5	19
All cases	100	100	100	100	100	100	100	100	100	100

<sup>1</sup> No cases reported or less than one-half of 1 per cent.

<sup>2</sup> Consists of savings accounts in banks and shares in savings and loan associations and credit unions.

NOTE:—Details may not add to totals because of rounding.

Source: "1959 Survey of Consumer Finances—The Financial Position of Consumers," *Federal Reserve Bulletin*, July 1959, p. 715.

six months before and six months hence" and "opinions about current and anticipated economic conditions (business, employment, and household income)" broken down by income groups, the respondents' opinions being categorized as "good," "normal," "bad" or "other" (i.e., "no opinion" or "not determined"). Information is also reported on consumers' "plans to buy automobiles, homes, home improvements and accessories, and appliances within six months."

**CONSUMERS' LIQUID ASSETS.** Consumers' buying plans are influenced, especially in regard to such "big ticket" items as automobiles and major appliances, by the size of their holdings of liquid assets, i.e., cash and other assets readily convertible into cash (e.g., balances in checking and savings accounts, shares in savings and loan associations, deposits in credit unions, U.S. savings and other government bonds, and readily marketable stocks and bonds). Even though a consumer may actually buy with current income, the freedom with which he spends is influenced by his accumulation of liquid assets. For retired and unemployed individuals, liquid assets may be used to buy everyday necessities. For other consumers, liquid assets may be used to meet major medical bills and other emergencies. Exhibit 7.6 shows some of the types of liquid assets held by different income groups in early 1959.

**CONSUMER CREDIT.** Through the ability to buy now and pay later, a consumer can command more purchasing power than that represented by his current income. Availability of consumer credit has greatly influenced the pattern of consumer spending. In 1958, for example, more than six in ten new car buyers and five in ten used car buyers bought on credit.<sup>15</sup> Exhibit 7.7 shows the distribution of "personal" debt within income and age groups for early 1959. Personal debt includes all short- and intermediate-term consumer debt other than charge accounts, and excludes mortgage and business debt. Personal debt, thus defined, is equivalent to instalment credit—i.e., the consumer pays his debt in a number of instalments. Notice that 60 per cent of all spending units reported such debt and 29 per cent had personal debts of \$500 or more. As might be expected, personal debt is most common among younger consumers, a group that includes heavy purchasers of major appliances and furniture. The fact that the size of income is directly related to the amount of credit a consumer can obtain also shows up in this table. Lower income groups tend to have either no debt or smaller amounts of debt than higher income groups.

The volume of instalment consumer credit outstanding at the end of March 1962 came to \$42.7 billion. Nearly 98 per cent of this instalment credit paper was held by commercial banks, sales finance companies, and

<sup>15</sup> "The Financial Position of Consumers," *Federal Reserve Bulletin*, July 1959, p. 705.

## Exhibit 7.7

*Personal Debt within Income and Age Groups, Early 1959*

[Percentage distribution of spending units]

<i>Income or age group</i>	<i>All cases</i>	<i>No debt</i>	<i>Some debt</i>	<i>Amount of personal debt</i>				
				<i>\$1-\$99</i>	<i>\$100-\$199</i>	<i>\$200-\$499</i>	<i>\$500-\$999</i>	<i>\$1,000 and over</i>
All spending units	100	40	60	10	7	14	11	18
1958 money income before taxes:								
Under \$1,000	100	58	42	19	9	6	2	3
\$1,000-\$1,999	100	57	43	14	10	12	4	4
\$2,000-\$2,999	100	44	56	12	11	17	10	6
\$3,000-\$3,999	100	36	64	11	7	16	14	16
\$4,000-\$4,999	100	32	68	14	6	14	16	17
\$5,000-\$5,999	100	30	70	9	8	16	14	23
\$6,000-\$7,499	100	29	71	5	7	16	16	27
\$7,500-\$9,999	100	31	69	5	4	11	15	33
\$10,000 and over	100	49	51	5	3	6	7	30
Age of head of spending unit:								
18-24	100	30	70	14	8	15	17	16
25-34	100	20	80	9	9	18	17	26
35-44	100	29	71	10	8	16	14	23
45-54	100	36	64	11	7	15	11	19
55-64	100	59	41	10	7	9	6	10
65 and over	100	74	26	9	6	5	3	3

NOTE.—Details may not add to totals because of rounding.

Source: "1959 Survey of Consumer Finances: The Financial Position of Consumers," *Federal Reserve Bulletin*, July 1959, p. 721.

credit unions. Department stores and other retail outlets held the remaining 12 per cent. On the same date, there was almost \$13.0 billion in noninstalment credit outstanding. Noninstalment credit, in the form of single-payment loans granted by commercial banks and other financial institutions, came to \$5.1 billion; charge accounts in department stores and other retail outlets accounted for another \$4.2 billion; and the remaining \$3.7 billion was service credit.<sup>16</sup> Since 1953, the volume of instalment consumer credit has been approximately three times the volume of noninstalment credit.<sup>17</sup>

**DISCRETIONARY INCOME.** When a family has money left over after buying such necessities as food, clothing, shelter, and transportation, it is said to possess discretionary income. During the 1950's, families with disposable personal incomes of less than \$4,000 generally had little or no discretionary income. But, as families moved above \$4,000, they had extra income with which they could exercise a number of options. As two writers expressed it in a *Fortune* article: <sup>18</sup>

They can buy better food and drink, or better furniture, or they can take a small flyer in the stock market; or conceivably, all of the extra income may go for one big fling in the luxury market (e.g., the \$5,000 family that saves for years to take a trip to Europe).

By the time that families move over the \$7,500 line, about half their income is discretionary, and the range of options is now so wide that it is no longer just a question of this purchase or that purchase, but of choosing a whole *style of life*. A skilled mechanic who earns \$7,500 after taxes may choose to continue living in "working class" style, meanwhile saving sizable sums for his children's college education; or he may choose to live like a junior executive in his own \$17,000 suburban house; or he may choose to live in a city apartment house otherwise occupied by business and professional men....

Some idea of the magnitude and distribution of discretionary income and a forecast of what may lie ahead are provided by the same two writers: <sup>19</sup>

At present, there is some \$135 billion of discretionary income in the U.S., i.e., of "after-\$4,000 income" to the family units that have it—and 60 per cent of U.S. family units have at least some of this after-\$4,000 money. Between now and 1970, these discretionary dollars will just about double, to around \$255 billion. *More than half of all disposable personal income will be discretionary by 1970. And the overwhelming bulk of this discretionary income, perhaps 85 per cent of it, will belong to the 25 million families with more than \$7,500.*

A family with discretionary income must decide whether to spend it, save it, or use it for both spending and saving. If we disregard the "forced" savings of the World War II period, past experience shows that a growth in discretionary income usually results in increased spending. After deciding to spend some or all of the increased income, a family must decide how to spend it. Discretionary income may be used to buy nondurables, durables, services (e.g., household operation, housing, and transportation), or some combination of these broad categories.

Some insights into the relationship between disposable personal income and spending on nondurables, durables, and services can be obtained

<sup>18</sup> S. S. Parker and L. A. Mayer, "The Decade of the 'Discretionary' Dollar," *Fortune*, June 1959, p. 136.

<sup>19</sup> *Ibid.*, p. 260. (Italics are in the original.)

from Figure 7.3, which is given below. Chart A in this figure is similar to the relationship portrayed in Figure 7.1.<sup>20</sup> In terms of dollars of constant purchasing power, and with other factors held constant, Charts B, C and D indicate that a given change in income, of say 10 per cent, is associated with a change of 21 per cent in the same direction for durables, 7 per cent for nondurables and 5 per cent for services. Chart A indicates that the same 10 per cent change in real income results in a change in the same direction of 8 per cent in total personal consumption spending.<sup>21</sup>

As shown in Chart B, even small fluctuations in income cause sharp repercussions in consumers' purchases of durables. Part of this situation traces to the fact that consumers are able to postpone or speed up their purchases of such durables as automobiles, furniture, and major appliances. If a family is temporarily short of income, it can always use the old refrigerator for another year or so. Or if the family finds itself suddenly with more discretionary income, it may decide to replace the refrigerator this year instead of next. The quick response of durable goods expenditures to income changes arises also from the wide use of installment credit in financing such purchases. Consumers are more willing to increase installment debt when income is rising and are more reluctant to incur additional indebtedness when income is declining. Lenders are also more agreeable to the process of debt creation in prosperous times. If we compare Chart C (nondurables) and Chart D (services) with Chart B, we can readily see that purchases of nondurables and services—much less postponable than purchases of durables—react far less violently to changes in income.

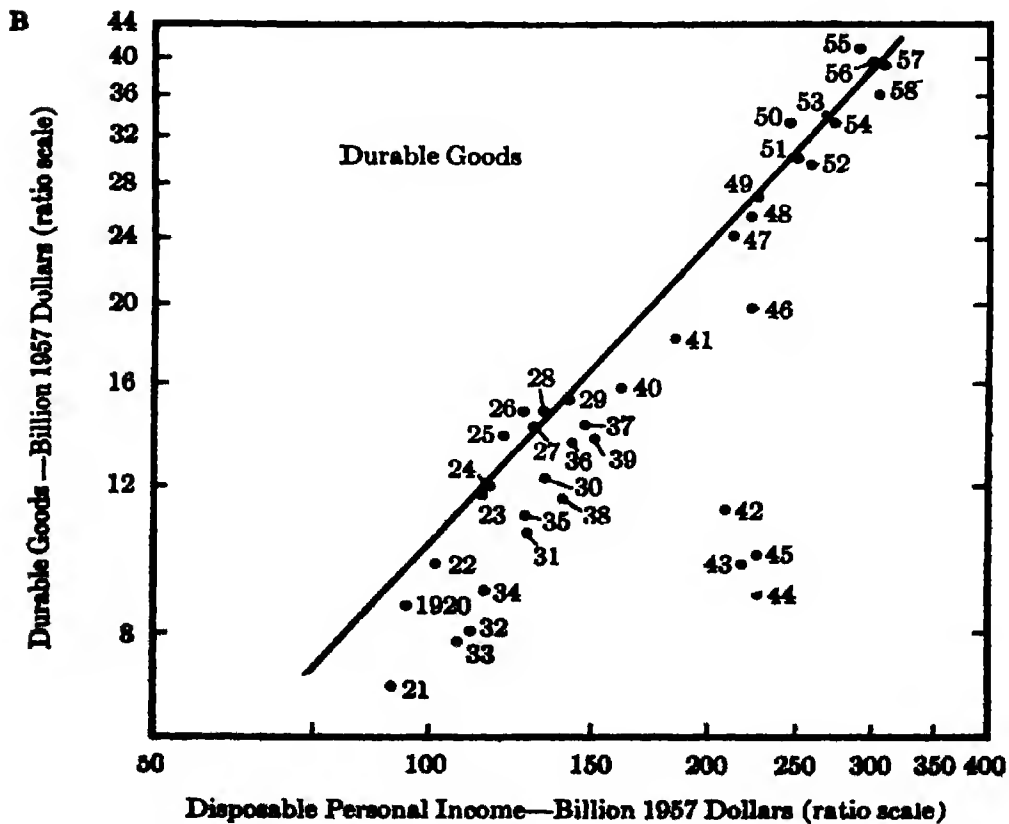
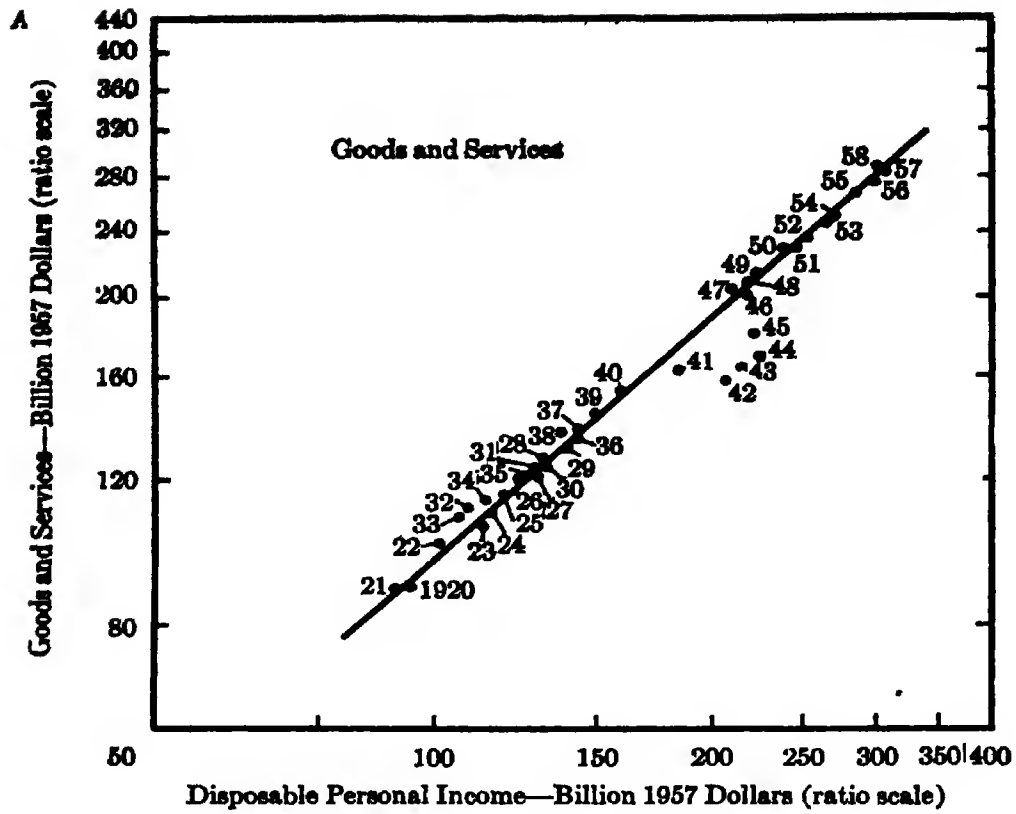
#### *Factors Affecting Business Spending*

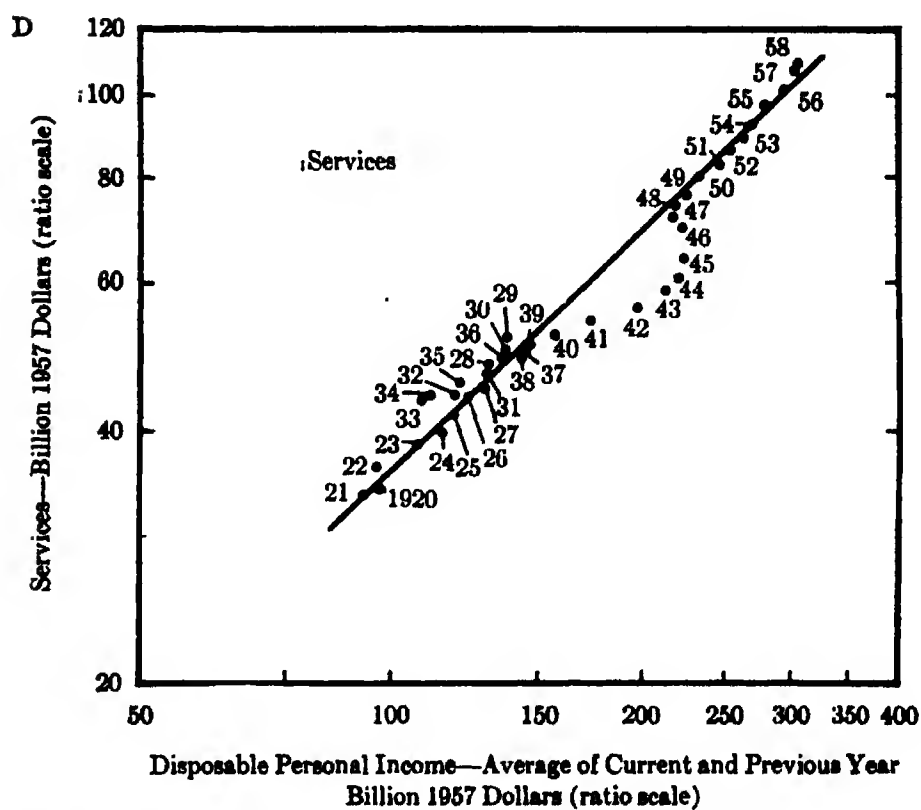
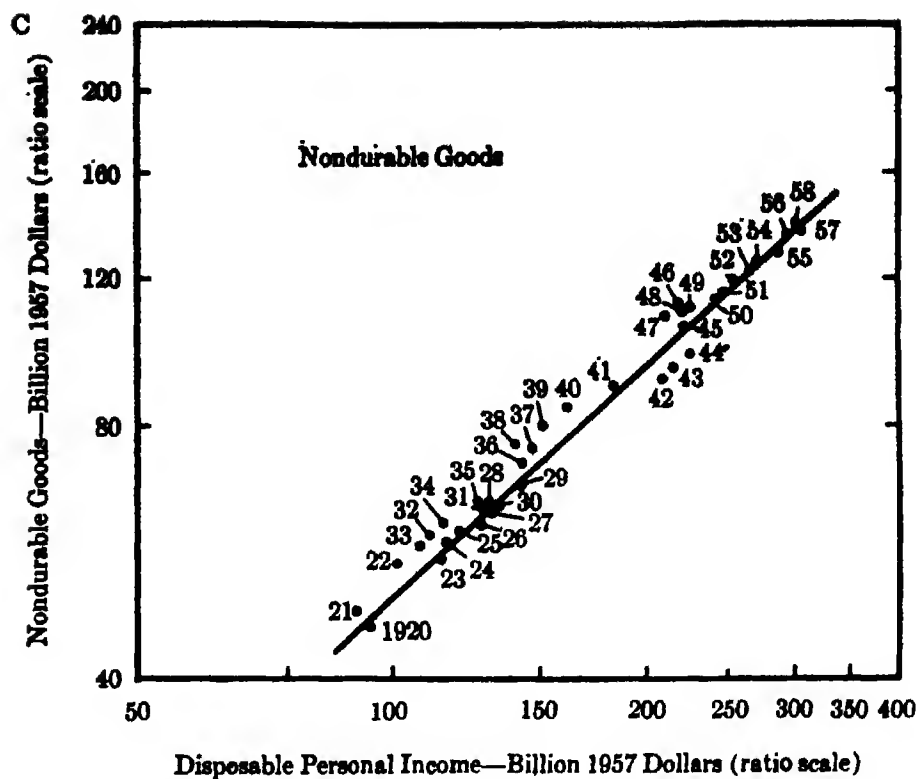
"Gross private domestic investment" contains the business counterpart of personal consumption spending. Marketers selling products in the industrial and the residential construction market are especially interested in the factors that affect this component of g.n.p. Usually, about three-quarters of gross private domestic investment is accounted for by business spending (on plant, machinery and equipment, and on inventories). The remaining one-quarter consists of investments made by individuals

<sup>20</sup> However, in Chart A the two axes are ratio scales and all values are in "constant" dollars (in this case, 1957 dollars) rather than (as in Figure 7.1) in current dollars. Charts B, C, and D are constructed in the same way. The ratio-scale construction permits direct comparisons of percentage changes in disposable personal income with percentage changes in expenditures. Constant dollars are used instead of current dollars in order to eliminate the effect of changes in the purchasing power of the dollar.

<sup>21</sup> For a compilation of sensitivity coefficients of personal consumption expenditures to changes in disposable personal income for specific products and services, see: L. J. Paradiso and M. A. Smith, "Consumer Purchasing and Income Patterns," *Survey of Current Business*, March 1959, p. 25.

Figure 7.3





Source: L. J. Paradiso and M. A. Smith, "Consumer Purchasing and Income Patterns," *Survey of Current Business*, March 1959, p. 22.



in new family-size housing units. The factors affecting investments by individuals in new residential construction are similar to those affecting personal consumption spending. Generally, individual investments in new residential construction resemble consumer spending for durable goods in the way they react to changes in disposable personal income.

The factors affecting the business spending portion of gross private domestic investment are more complex. Business spending, i.e., business investment, depends largely on businessmen's appraisals of opportunities for profits. Economists use a special concept, the *marginal efficiency of investment*, to describe the anticipated net return on a given investment. Marginal efficiency of investment depends on such matters as the sales and profit outlook for the products manufactured and/or marketed by the enterprise, the chances that investment will improve manufacturing or marketing efficiency or both and thus bring down the costs of doing business, the corporate income tax rate (businessmen are inclined to compute rates of return on investments *after taxes*), and the general business outlook. Businessmen compare the marginal efficiency of investment with the costs of obtaining money to invest in order to determine whether a given investment will "pay out" a sum sufficient to cover the risks involved. Money for business investment is obtained from the personal savings made by individuals, from what business itself "saves" in the form of retained earnings, and from funds set aside to cover the depreciation of business assets.

**THE "MULTIPLIER" EFFECT.** Changes in business investment cause rather exaggerated changes in consumer income. If business investment is increased, the investment is eventually paid out in the form of income to people who are also consumers. Consumers save part of their increased incomes but spend the larger portion. This spending, in turn, becomes additional income to other consumers who also save but re-spend most of the extra money. Again and again this re-spending and income-generating process is repeated. The *multiplier* is the name given the number of times the final increase in income exceeds the new investment. If the marginal propensity to consume is known, it is possible to compute the multiplier. For example, if the marginal propensity to consume is .90, the multiplier is computed as follows:

$$\text{Multiplier} = \frac{1}{1 - \text{m.p.c.}} = \frac{1}{1 - .90} = \frac{1}{.10} = 10$$

In this illustration, then, \$1 of new business investment results ultimately in an addition to income of \$10 (\$1 × 10). The multiplier effect explains how a change in business investment can cause consumer in-

come to fluctuate widely. As indicated earlier, however, there are many factors that affect income, and business investment is only one.

**THE "ACCELERATION" PRINCIPLE.** Just as business investment affects consumer income and consumer spending, so does consumer spending have a reverse effect on business investment and spending. This effect is called the "acceleration" principle. The principle itself traces to the fact that the demand for industrial goods *derives* from the demand for the final products which find their way to consumers. Quantitative changes in the sales of a final product tend to cause greatly magnified changes in the production and sale of the industrial goods used to make that final product. Operation of the acceleration principle is illustrated in Exhibit 7.8. Note the assumptions listed at the bottom of this table. In base year

**Exhibit 7.8****The "Acceleration" Principle Illustrated**

<i>Year</i>	<i>Unit Demand for Product X  (Final Product)</i>	<i>Machines for Making Product X in Use</i>	<i>Demand for Replace- ment Machines</i>	<i>Demand for Additional New Machines</i>	<i>Total Demand for Machines</i>
Base	50,000 units	50	5	0	5
Base plus 1	55,000 "	55	5	5	10
Base plus 2	65,000 "	65	5	10	15
Base plus 3	62,000 "	62	3	0	3
Base plus 4	57,000 "	57	0	0	0

*Assumptions:*

1. This firm is the sole maker of the machines used to produce product X, and these machines can be used for no other purpose.
2. The 50 machines in use during the base year are evenly spaced as to age, and average machine life is 10 years. In the base year, 10 per cent of the machines are in the 10th year of use, 10 per cent are in the 9th year, etc.
3. Each machine is used to full capacity and produces 1,000 units of product X per year.
4. There is no unused production capacity in the base year, and each year everything that is produced is also sold.

plus one, there is a 10 per cent increase in the demand for the final product, product X, and this causes a 100 per cent increase in the demand for the machines used to manufacture product X. Demand for product X increases again in base year plus two, and machine demand rises by 50 per cent over the year before. In base year plus three, demand for product X declines by 3,000 units (a drop of less than five per cent), but machine demand falls by 80 per cent. In base year plus four, product X demand declines another 5,000 units (a little over 8 per

cent), and machine demand is non-existent. The acceleration principle also tends to operate in both the accumulation and the liquidation of inventories by the manufacturers, wholesalers, and retailers in response to changes in consumer spending resulting from changes in consumer income. However, the principle is mainly used as an analytical framework in which to study the often drastic fluctuations in demand occurring in industries producing capital goods and equipment.

### *The Effect of Government Spending*

Neither the income-expenditures model nor any other model of the economy would be very realistic if it ignored the roles of government as a spender and tax collector. In Exhibit 7.2, we notice that, in 1961, the \$107.4 billion of government purchases of goods and services amounted to more than one-fifth of the gross national product. In fact, when g.n.p. is analyzed from the "expenditures and investment side," government spending is second in size only to personal consumption spending and far exceeds the third largest component, namely gross private domestic investment.

In the income-expenditures model, government exercises significant controls over the flow of national income. In siphoning off part of national income as it collects taxes, it shrinks the amounts individuals and businesses have for consumption and investment spending purposes. It adds to the flow of national income when it buys goods and services—providing individuals and businesses with more funds for consumption and investment expenditures. If the amount of income drained off as taxes equals the amount of government spending, government's influence is neutralized. But, if government spending exceeds total taxation, there is a net addition to national income. The reverse situation also holds: if total taxation is larger than government spending, there is a net reduction in national income. This, then, is how government fits into the income-expenditures model: it exerts a stimulating or repressing influence on market demand. It should also be mentioned that the government exerts other influences on market demand through its power to control the quantity of money in circulation. Government controls the quantity of money mainly by making loans and granting loan guarantees and by influencing the reserve needs of banks through regulation by the Federal Reserve System.

### **CONCLUSION**

In this chapter, we have considered the major uncontrollable economic determinants of market demand. Although the marketing man can exert only indirect influences over these determinants, he must nevertheless take them into account as he plans

and directs such controllable elements as advertising, personal selling, pricing, and product innovation. Sorting theory, in which consumers are visualized as building highly individualized assortments of goods, provides a conceptual framework which helps to explain consumer buying behavior. The income-expenditures model, a much more complex conceptual framework, helps the marketing man to understand the other major uncontrollable economic determinants of market demand. Disposable income is the chief, but by no means the only determinant of personal consumption spending. Significant changes occur in the spending and saving patterns of families as they increase in size or shift from one income bracket to another. Credit serves as purchasing power by exchanging claims to future income for present spending. Rises in discretionary income and changes in its distribution among families are likely to have marked effects on spending patterns for durables, nondurables, and services. Business spending and investment enters into the income-expenditures model both with respect to the way it generates income and the way income accelerates it. Similarly, government also plays a dual role in the model. No part of the model operates independently. Each part (consumers, businesses, and government) influences and is influenced by all the others. Interactions among the parts, such as those evident in the multiplier effect and the acceleration principle, show how strongly the sectors of our economy are bound together.

#### QUESTIONS AND PROBLEMS

1. Explain and contrast the terms in each of the following pairs:
  - a. conglomeration, assortment
  - b. core market, fringe market
  - c. gross national product, national income
  - d. personal income, disposable personal income
  - e. the consumption function, the marginal propensity to consume
  - f. disposable personal income, discretionary income
2. Show how sorting theory can be used to explain the economic process whereby conglomerations are converted into assortments.
3. In terms of the four types of sorting, demonstrate how marketing theory differs from economic theory.
4. Demonstrate how sorting theory might be applied in explaining the buying behavior of consumers.

5. "The survival of a firm requires that it present, to some group of buyers, a differential advantage over all other suppliers." List some forms of differential advantage, and give examples of companies presenting each form.
6. Of the many factors affecting the strength of market demand, why is income considered the most powerful?
7. Using an example of your own, demonstrate the "circular" flow of income. Of what significance is this for marketing?
8. Discuss the relationships which exist among the following: production, consumption, purchasing power, disposable personal income.
9. Why are marketing analysts usually more interested in the marginal propensity to consume than they are in the average propensity to consume? Would this be as true of the analyst of the market for sports cars as of the analyst of the market for breakfast cereals? Why?
10. What possibilities are there for influencing the propensity to consume through such marketing activities as advertising, personal selling, trading stamp plans, liberal credit terms, and so on?
11. "Marketing men have a vested interest in shifting the peak of the income distribution curve as far to the right as possible." Explain and evaluate this statement.
12. What is meant by a consumer "planning horizon"?
13. Of what significance, if any, would studies of consumers' income expectations be for: (a) a manufacturer of tape recorders; (b) a mail-order house specializing in "do-it-yourself" electronic kits; (c) a manufacturer of tires for passenger cars; (d) a manufacturer of photographic equipment and supplies?
14. One young married man recently used the instalment plan to buy a new automobile and to furnish his newly-purchased house (which was financed through a 30-year mortgage). When the young man told his father about this, the older man was horrified and said, "Your mother and I got where we are today because we saved our money, paid cash for all major purchases, and never paid a dime of interest to an instalment seller." The son replied, "If I waited to pay cash for these things, I would have a long grey beard before I could enjoy them!" Which side of this argument would you take and why?
15. Of what significance would a forecast of the magnitude and distribution of discretionary income be for: (a) a chain of

grocery supermarkets; (b) a manufacturer of patio and outdoor furniture; (c) a major domestic airline; (d) an importer of Scotch and Canadian whiskies; (e) a local transit company?

16. How much additional consumer income will be generated if in some year "gross private domestic investment" rises from \$75 billion to \$80 billion, and if the marginal propensity to consume is estimated to be .92? Explain how this information might be used by the management of a nation-wide chain of department stores.
17. Refer to Exhibit 7.8, and explain how the manufacturer of the "machines used for making Product X" might use the acceleration principle in forecasting sales and in planning his marketing operations.
18. Why do you think a company selling tire-making machines might carry on an advertising program directed not to potential buyers of tire-making machines but to potential buyers of tires? Does this sort of strategy make sense for any company whose product has a derived demand? Why?
19. Explain the various influences exerted by government spending and taxation on market demand.
20. "Automation and other technological changes have greatly increased the efficiency with which capital can be used, so it now is taking fewer dollars of new investment to produce a dollar's worth of output. This drop means new investment projects now require less cash—hence, they create fewer jobs and less purchasing power." Comment on this statement and interpret its significance for marketing.

PSYCHOLOGICAL

FACTORS

AFFECTING

CONSUMER

DEMAND

# 8

Although economic theories and concepts are useful in analyzing many aspects of consumer demand, there are aspects of consumer demand which can be explained only in terms of psychological theories and concepts. Why do consumers act the way they do? Why do individual consumers exhibit certain attitudes? Psychology, focusing mainly on the "internal" forces directing the activities of individuals, attempts to provide answers to such questions. Where the economist makes assumptions about the motivations of consumers, the psychologist attempts not only to describe but to explain these motivations. Thus, in explaining consumer behavior, psychology takes

up the task where economics drops it. It is not surprising, then, that in its treatment of the practical problems of moving goods, marketing has often seemed more to resemble applied psychology than economics.<sup>1</sup>

There have been three major approaches to the development of a psychological theory of consumer motivation: the laboratory or experimental, the clinical, and the Gestalt. Laboratory psychology has concentrated on physiological tensions or body needs as motivational forces and has experimented both with human beings and animals. In clinical psychology, the basic physiological drives are examined as they are modified by social forces. Frequent conflicts between basic needs and social restrictions may result in repression of motives, which, nevertheless, may still exert strong driving forces on human actions. Clinical psychologists attempt to uncover these repressed and unconscious motives through the use of psychoanalytical techniques such as depth interviewing. Depth interviews are conducted as informal, lengthy and unstructured conversations in which the interviewer attempts to uncover unexpressed, and frequently unrecognized, reasons for the actions of the person interviewed. Gestalt psychology, often called social psychology, regards the individual and his environment as an indivisible whole. The individual always reacts in an environment, and actions must be viewed both in terms of the individual and the environment. Furthermore, in Gestalt psychology, individual behavior is considered to be directed toward a goal or goals, and to be the resultant of both the motives of the individual and his reaction to the environment. Each approach adds to our understanding of human behavior. Thus far, no single psychological theory of consumer motivation is completely adequate or satisfactory for all purposes and, consequently, marketing has borrowed theoretical concepts which seem most applicable and fruitful in particular instances.<sup>2</sup> Some of the theories and concepts borrowed by marketing from psychology are examined below.

### LEARNING THEORY

Studies of learning and the related areas of recognition and recall and habitual response have furnished marketers with a number of keys to the understanding of consumer behavior and with concepts especially useful in planning and implementing programs designed to stimulate consumer demand. Concepts borrowed from learning theory help in answering such questions as these: How do consumers learn about products

<sup>1</sup> "The Motivation of Consumer Buying," *Cost and Profit Outlook*, Vol. VII, No. 1 (January 1954), p. 1.

<sup>2</sup> H. Herzog, "Behavioral Science Concepts for Analyzing the Consumer," in D. J. Duncan (Ed.), *Proceedings: Conference of Marketing Teachers from Far Western States* (Berkeley: University of California, 1958), p. 33.



offered for sale? How do they learn to recognize and recall these products? By what processes do they develop habits of purchase and consumption?

In studying the learning process, psychologists have been greatly influenced by the associative bond concept, also known as connectionism, which found its chief exponent in Thorndike.<sup>3</sup> In considering any unit of activity of the individual, Thorndike saw three aspects: first, a *stimulus* or situation affecting the individual; second, a *response* by the individual; and third, a *connection* between the stimulus and response enabling the former to produce the latter. This connection is called the S-R bond. Thorndike and his followers came to regard learning as a process involving the building of new bonds and organizing these into systems of bonds. The newer trend in psychological thinking is to regard the S-R bond concept as an oversimplification, to look instead at the total experience of the individual, and to consider learning a process in which total functions are altered and rearranged to make them more useful to the individual. Particular stimuli will not always activate predictable responses, because motives and other factors internal to the individual also affect responses to external stimuli. What does this mean for the marketer? Simply that the consumer is influenced not only by external stimuli—e.g., the marketer's advertising and promotional efforts—but also by internal factors.

What are the basic factors influencing learning? One writer states that repetition, motivation, conditioning, and relationship and organization are all important.<sup>4</sup> However, as we shall see, these have different degrees of relevance for marketing.

Repetition, necessary for the progressive modification of psychological functions, must be accompanied by attention, meaning, interest, and a goal if it is to be effective. Mere repetition of situations or stimuli does not promote learning, and advertisers who depend on it alone are wasting both their efforts and their advertising dollars.

The motives of an individual are the most important factors involved in initiating and governing his activities. Activity in harmony with one's motives is satisfying and pleasing, but activity not in harmony with one's motives is annoying at best and frustrating at worst. When, in a given situation, an individual has several motives, they may either reinforce each other, which promotes learning, or be in conflict, which hinders learning. The motivation of individuals is a topic of considerable interest to marketing professionals, especially those responsible for preparing

<sup>3</sup> See: E. L. Thorndike, *Human Learning* (New York: Appleton-Century, 1931), pp. 117-122.

<sup>4</sup> H. L. Kingsley, *The Nature and Conditions of Learning* (New York: Prentice-Hall, 1946), pp. 69-165.

advertising and sales presentations. Neither they, nor psychologists, have thus far been able to reach more than partial agreement as to what constitutes even the most common or basic motives. Members of each group have drawn up lists of motives, but there is much opportunity for further research. One such list is presented and analyzed in a later section of this chapter.

Conditioning is a way of learning by which a new response to a particular stimulus is developed. For example, the sight of just any glass bottle does not evoke any standard response, but the sight of one particular type of bottle makes most Americans think of Coca-Cola. Through a long-range advertising campaign and continued exposure of this symbol, the Coca-Cola Company has conditioned the American public to recognize its bottle. The conditioned response establishes a temporary rather than a permanent behavior pattern and, if it is not frequently reinforced by the original stimulus, the conditioned response soon disappears. Thus, only by frequent and massive advertising and continued exposure of the bottle symbol has the Coca-Cola Company retained the conditioned response. Marketing men must remember, however, that all individuals do not react equally well to conditioning, nor are their reactions thus far predictable.

Meaningful relationships and organization are also factors which facilitate learning. Or, to put it another way, learning effectiveness is enhanced if the thing to be learned is presented in a familiar environmental setting. Thus, a salesman can more effectively demonstrate a vacuum cleaner by using it on the customer's carpet and showing her the dirt it has picked up than by describing its capacity and cleaning power. The housewife is interested in the performance specifications of the machine only as they are directly related to the job of cleaning her carpets. There are obvious implications in this for the advertiser and salesman. Sales messages should relate the products to the needs and interests of the consumer, if they are to be successful in attracting his attention and subsequent recall.

Marketing men have too often relied entirely on repetition and conditioning to achieve consumer "learning" about their products. Learning can take place in the absence of motivation and relation and organization, but it is a slow expensive process, and retention is poor. When an individual is strongly motivated, he may learn a task in one or two repetitions. A person who has been troubled with excessive tooth decay may hear just once about a promising new dentifrice that helps prevent decay, and he will remember the name and buy it; yet, another person who has never had a cavity in his life would only learn the name of the same dentifrice after countless repetition because he is not interested in decay prevention. Meaningful relation and organization also speed up the learn-

ing process. It is easier to remember the name Band-Aid than a name such as Acme Plastic Strips, because Band-Aid is a combination of syllables from bandage and first aid—words that describe the product—whereas Acme describes anything, and plastic strips is too general to connote bandages. Ignorance of the existence of and interrelationship between these four factors in learning has led many marketing men to rely almost solely on repetition and conditioning. Learning can be achieved with repetition alone, but, when product or market knowledge is meaningful and important to a consumer, he learns it quickly and almost unconsciously.

Particularly for the advertiser, but also for the planner of long-range promotional programs, there is significance in the psychological explanation of retention and forgetting. Retention can be explained in terms of impressions left in the nervous system as a result of learning. Forgetting, or “negative retention,” develops with the deterioration of these impressions. The more meaningful the material learned—i.e., the more the learner completely understands it—the greater the rate of retention and the lower the rate of forgetting.<sup>5</sup> Retention curves for both meaningful and unmeaningful materials, plotted as functions of time, drop most rapidly immediately after learning and then gradually decline until the material is almost or entirely forgotten. This phenomenon is particularly important with respect to long-run campaigns of promotion or advertising. Messages should be spaced closely enough so that they fortify the learning process. If they are too far apart, information learned from earlier messages will have been forgotten and must be entirely relearned.

#### SOME CONCEPTS FROM CLINICAL PSYCHOLOGY

The principal research techniques employed in the relatively new field of motivation research have been designed primarily according to concepts originally developed by clinical psychologists. Among the most important concepts borrowed from clinical psychology are those of the unconscious, rationalization, projection, and free association.<sup>6</sup>

The concept of the unconscious originated with Sigmund Freud, the founder of psychoanalysis. Freud believed that consciousness was only a small part of the total mind, that, like an iceberg, its larger part existed below the surface of awareness.<sup>7</sup> According to Freud, the mind contains ideas and urges, some of them conscious ones and some beneath the

<sup>5</sup> J. P. Guilford, *General Psychology*, 2nd ed. (New York: Van Nostrand, 1952), p. 406.

<sup>6</sup> J. W. Newman, *Motivation Research and Marketing Management* (Boston: Harvard Graduate School of Business Administration, Division of Research, 1957), pp. 64-66.

<sup>7</sup> C. S. Hall, *A Primer of Freudian Psychology* (New York: Mentor edition published by arrangement with The World Publishing Company, 1954), p. 54.

threshold of consciousness, all, however, influencing behavior. The fact that people are not usually consciously aware of their motives explains why consumers are often unable to explain their real reasons for buying or not buying. Recognizing the existence of the unconscious mind, motivation researchers have resorted to indirect research approaches such as depth interviewing.<sup>8</sup> More conventional research approaches, such as direct questioning, have been unable to provide data sufficiently reliable to justify predictions of consumer behavior. One mail-order house, for instance, took advance proofs of catalog pages to a number of women, asked them which style of dress and which colors they preferred, and then tabulated the most popular and least popular styles and colors. Actual sales, however, showed no correlation with the preferences recorded in the survey.<sup>9</sup> Practical marketers, of course, have known for a long time that there are often wide discrepancies between what people say they will buy and what they actually do buy.<sup>10</sup>

Rationalization, a psychiatric concept, has long been put to practical use by advertisers but has only recently been reflected in the research techniques used in investigating consumer behavior. Rationalization is described as the mental process of finding reasons to justify an act or opinion which is actually based on other motives or grounds, although this may or may not be apparent to the rationalizer.<sup>11</sup> In advertising, rationalization often takes the form of providing a reader or listener with a plausible, acceptable reason for buying in situations where the prospect may be unwilling, consciously or unconsciously, to admit the real buying reason. For instance, the manufacturer of an expensive, showy automobile provides an "acceptable reason for buying" by stressing such features as economy in operation and high trade-in value. In some situations, rationalization is provided by the purchaser personally. For instance, take the case of the woman who buys a mink coat to impress her friends. She explains the purchase to them by saying it is warmer and will wear longer than a less expensive coat. Thus, the most common kind of rationalizing is the attempt to justify decisions or actions by finding "good" reasons for them.<sup>12</sup> The prevalence of rationalization in our society explains why such direct questions as "why did you buy this?"

<sup>8</sup> For a highly entertaining account of the controversy stirred up by the increasing use of depth interviewing in consumer studies, see: P. Stryker, "Motivation Research," *Fortune*, June 1956, pp. 144-147 and 222-232.

<sup>9</sup> B. B. Gardner, "The ABC of Motivation Research," *Business Topics*, Vol. 7, No. 3 (Summer 1959), pp. 35-41.

<sup>10</sup> However, for a timely and well-worded warning to management not to rely blindly on motivation research, see: T. Levitt, "M-R Snake Dance," *Harvard Business Review*, Vol. 38, No. 6 (November-December 1960), pp. 76-84.

<sup>11</sup> E. K. Strong, Jr., *Psychological Aspects of Business* (New York: McGraw-Hill, 1938), p. 129.

<sup>12</sup> N. L. Munn, *Psychology*, 3rd ed. (Boston: Houghton Mifflin, 1956), p. 149.

or "what were your reasons for buying?" so often fail to uncover the real buying motives. Thus, where it is suspected that rationalizing is a factor in consumer decision-making, indirect research approaches, such as depth interviewing, are used.<sup>13</sup>

Projection is another concept borrowed from clinical psychology. It is the name given to the type of reaction which occurs when a person, seeing someone facing a certain problem or situation, interprets the other person's reactions in terms of his own. In other words, he ascribes his own motives to that other person. Putting the projection concept to practical use, motivation researchers have designed their so-called projective techniques. Such techniques provide a means for uncovering consumers' hidden or unconscious motives and attitudes. For example, the *stimulus picture* is a type of projective technique. Such pictures were used in one study designed to secure information from farmers and their wives as to which "reference groups" influenced their decisions to buy new products.<sup>14</sup> Respondents were handed seven stimulus pictures showing a farmer with a number of different reference groups, and referents, such as family, neighbors, friends, county agent, and an agricultural scientist. Respondents then were asked such questions as "What is going on in this picture?" "Who are the people in this picture?" "How do they feel toward each other?" "How important is it to each of the people what the others think of him?" The tape recordings of the interviews made it clear that the respondents were usually concerned with "the farmer in the picture."<sup>15</sup> Virtually all projective techniques have two things in common: First, they are designed to elicit a range of responses rather than a single stereotyped and predictable reaction. And second, they are constructed so as "to entice the subject into revealing himself without his being aware of the fact that he is doing so."<sup>16</sup>

The principle of free association, which traces to Freud and is used extensively in psychoanalysis, has also been put to use by motivation researchers in developing indirect research techniques. As Newman says, "the basic idea is that if a person gives up the usual logical controls he exercises over his thoughts and says whatever comes into his mind at the moment in the presence of a skilled listener, unconscious feelings and

<sup>13</sup> For a popularized description of six different approaches to indirect research of the consumer, see: J. M. Vicary, "How Psychiatric Methods Can Be Applied to Market Research," *Printers' Ink*, May 11, 1951, pp. 39-48.

<sup>14</sup> Reference groups are those groups with which particular individuals would prefer to be associated. Each individual accepts the behavior norms of his reference group as he makes decisions and takes action.

<sup>15</sup> E. M. Rogers and G. M. Beal, "Projective Techniques in Interviewing Farmers," *The Journal of Marketing*, Vol. 23, No. 2 (October 1958), pp. 177-179.

<sup>16</sup> OSS Assessment Staff, *The Assessment of Men* (New York: Rinehart, 1948), p. 71

thoughts can be discovered."<sup>17</sup> Thus, the techniques of depth interviewing represent an application of the principle of free association. Using a variation of depth interviewing, the "semantic differential" (a technique designed to quantify highly subjective concepts by forcing answers onto a seven point scale), two University of Rochester psychologists performing a study for an advertising agency answered, among other things, the question, "Why does a woman visit department stores?"

Primarily to keep abreast. A store is her chief source of information. In a store she learns what is new, what is right, what is changing. She uses the store as a stage. It is a place where she daydreams, acts out her hopes and desires.<sup>18</sup>

Many of the depth interviewing techniques take the form of word association tests in which respondents are asked to give the first word that comes to mind for each of a list of unrelated words. Given the word *snow*, for example, the respondent might reply *shovel*. Among the many applications of the word association tests are those of screening possible names for new products, measuring the penetration of advertising appeals, and approximating the market shares of different competitors.

#### IMAGERY AND MARKETING

Images are the formalized impressions residing, consciously or unconsciously, in the minds of individuals with regard to given subjects. One source says that images can be thought of as pictures which arise somehow before the "inner eye," or sounds which are heard by the "inner ear."<sup>19</sup> Patterns of buying behavior are influenced by the images consumers have of different products, particular brands, companies, retail outlets, and of themselves. It follows that differences between individuals, products, brands and the like result in different images, but these need not be based on real or measurable differences. For instance, the functional characteristics of two brands may be essentially identical, but purely subjective factors are likely to conjure up quite different images of the two brands. All brands of aspirin are identical in composition, since it is a chemical compound; yet they do not all have identical brand images. A single factor, an old and established reputation, increases consumer confidence and makes it possible for the manufacturers of Bayer Aspirin to sell their product at premium prices. Because such

<sup>17</sup> Newman, *op. cit.*, p. 65.

<sup>18</sup> H. Nowlis and V. Nowlis, *Bumrill Letter*, February 1960.

<sup>19</sup> G. H. Smith, *Motivation Research in Advertising and Marketing* (New York: McGraw-Hill, 1954), p. 8.

images definitely affect consumer buying behavior, marketers and advertisers are increasingly taking them into account in drafting promotional plans and programs. Consequently, motivation research is being used not only to identify the nature of images but to detect the implications for marketing action.

### Self-Image

The self-image is the picture a person has of himself—the kind of person he considers himself, and the kind of person he imagines others consider him. What lies behind this image and what causes it to be the type of image it is? No one seems to have a complete or clear explanation of the self-image. But it is apparent that the complex of impressions which results in the self-image is affected both by physiological and psychological needs, some conscious and some unconscious. Among the needs at the level of consciousness, to complicate matters further, are certain ones which the individual willingly discusses and others which he is unwilling to admit. Some of these needs are partially shaped, or at least influenced, by socio-economic factors such as education, sex, occupation, age, cultural background, amount and source of income, memberships in and relationships to different social groups, and regional and local customs and mores. But behind the self-image also lie those internal psychological factors which determine the individual's personality, his stage of intellectual development, and the extent of his emotional maturity.

Different people have different kinds of self-image and, from the standpoint of marketing, this gives rise to market segmentation along psychological lines. For instance, the woman who sees herself primarily as a good housewife and mother exhibits a different total pattern of buying behavior than does the woman who sees herself as a social leader or professional careerist. One of the basic tenets of motivational research is that in many buying situations an individual prefers to buy those products and brands whose images appear to be consistent with his self-image.<sup>20</sup> However, it must be pointed out that the power of the self-image as a buying influence varies from individual to individual,

<sup>20</sup> There is conflicting evidence as to the importance of the self-image in some buying situations. For instance, H. G. Baker, an executive of the now-defunct Edsel Division, Ford Motor Company, is on record as saying "A make thus becomes a very real extension of the owner's DESIRED personality, and something he derives gratification from, if the personality fits." See: H. G. Baker, "Sales and Marketing Planning of the Edsel," in R. L. Clewett, *Marketing's Role in Scientific Management* (Chicago: American Marketing Association, 1957), p. 130.

But the findings of one empirical study challenge this notion that the buyers of one make of automobile possess different personalities than the buyers of a competing make. See: F. B. Evans, "Psychological and Objective Factors in the Prediction of Brand Choice: Ford Versus Chevrolet," *The Journal of Business*, Vol. 32, No. 4 (October 1959), pp. 340-369.

and even with the same individual as he makes different buying decisions at different times.

Segmentation of the consumer market along psychological lines must be based on more than differences in self-images. This is because consumer buying behavior is also determined by such psychological factors as habit, cognition (knowledge or recognition), and learning. One psychologist, for example, suggests that the market for consumer products is composed of six main segments: <sup>21</sup>

1. *A habit-determined group* of brand loyal consumers, who tend to be satisfied with the last purchased product or brand.
2. *A cognitive group* of consumers, sensitive to rational claims and only conditionally brand loyal.
3. *A price-cognitive group* of consumers, who principally decide on the basis of price or economy comparisons.
4. *An impulse group* of consumers, who buy on the basis of physical appeal and who are relatively insensitive to brand name.
5. *A group of "emotional" reactors*, who tend to be responsive to what products symbolize and who are heavily swayed by "images."
6. *A group of new consumers*, not yet stabilized with respect to the psychological dimensions of consumer behavior.

#### *Product Image*

A product image is a stereotype which is conjured up by an individual when he thinks of the product. Most products have not one but several images. For example, some consumers may consider a motor boat a means of conveyance over water with a specified load capacity and the power and speed necessary to perform its function. Other consumers, probably the majority, think of the same boat as a means of exciting the interest, admiration, and even the envy of people they wish to impress. They may be more interested in the "status symbol effect," e.g., the visual impact and styling, than in seaworthiness and maneuverability. Individual consumers may select an outboard motor with far more horsepower than they actually need, for the prestige such a motor may bring. Indeed, some individuals apparently receive more satisfaction from owning such a boat (and having others aware of the fact) than they do from operating it.

Psychologists use the term ego-involvement to describe the sort of situation in which the consumer seeks to identify his self-image with the product image. Some products have a high capacity for ego-involvement,

<sup>21</sup> W. A. Woods, "Psychological Dimensions of Consumer Decision," *Journal of Marketing*, Vol. 24, No. 3 (January 1960), p. 17. Segment 5, the "emotional" reactors, is the group that has been so much studied through the techniques of motivation research.



others have less, and some have none at all. This has led one psychologist to classify consumer products according to their demands on the consumer: <sup>22</sup>

A. Demands of ego-involvement in the external symbols which the product conveys

1. *Prestige products.* Products in this group not only represent some image or personality attribute, but become that attribute. Includes automobiles, homes, clothing, furniture, art objects, newspapers, and magazines. These products serve the function of extending or identifying the ego of the consumer in a direction consistent with his self-image, in such a way as to give him individuality.
2. *Maturity products.* These are products which because of social customs are typically withheld from younger people. Initial use of such products symbolizes a state of maturity on the part of the consumer. Intrinsic product merit is not a factor, at least in the initial stages of use. Includes cigarettes, cosmetics, coffee, beer, and liquor.
3. *Status products.* These products serve the function of imputing class membership to their users. The intrinsic merit of products in this class is an important factor in continued usage. However, consumers tend to select "big-name" brands because they believe such brands impute "success," "substance," "quality," or similar attributes. Packaged foods and gasoline are often in this class. Where prestige products connote leadership, status products connote membership.
4. *Anxiety products.* Those products which are used to alleviate some presumed personal or social threat. This class includes soaps, dentifrices, "health" foods, perfumes, and razors. This class involves ego-defense, whereas the three previous classes are concerned with ego-enhancement.

B. Hedonic demand

5. *Hedonic products.* These are products which are highly dependent on their sensory character for their appeal. Moreover, their appeal is immediate and highly situational. This category includes snack items, many types of clothing, pre-sweetened cereals. Visual (style) features of any product fall within this area: automobile design and color are examples.

C. Functional demands

6. *Functional products.* These are products to which little cultural or social meaning has, as yet, been imputed. Included in this class are the staple food items, fruits, vegetables, and most building products.

Now, in spite of the fact that products may be placed into neat psychological categories, such as those above, marketers have known for a long time that different consumers attach different meanings to the same prod-

<sup>22</sup> Woods, *op. cit.*, pp. 17-18.

uct. The psychological character which a product has is a true character which has been imputed to it by society as a whole through long periods of time, and is independent of the psychological character (or personality) of particular individuals.<sup>23</sup> Psychological research is often necessary to uncover and identify the different images people associate with the product. Sometimes, users and non-users have quite different images of the product. Although simple marketing research techniques of the question-and-answer variety can separate the users from the non-users, more sophisticated techniques, such as the projective ones, are required to explain the reasons for non-use. A famous pioneering study, utilizing projective techniques, was conducted by Mason Haire in an effort to determine the reasons for non-use of instant coffee. Blind taste-tests had shown that most consumers could not detect a flavor difference between instant and regular coffee, but direct questioning continued to show "different flavor" as the primary reason for non-use. Haire made up two shopping lists, identical in all respects except that one included a brand of regular coffee and the other included Nescafe. Making alternate use of each shopping list, and with no respondent being aware of the other list, Haire asked one hundred housewives to "Read the shopping list. Try to project yourself into the situation as far as possible until you can more or less characterize the woman who bought the groceries. Then write a brief description of her personality and character." A significant number of the respondents described the purchaser of Nescafe as lazy and a poor planner.<sup>24</sup> Since the time of this study, instant coffee manufacturers have de-emphasized the prepared food character of their product and the proportion of non-users has steadily declined. Evidently, then, they have been successful in modifying the product image of instant coffee for increasing numbers of consumers.

That different classes of users of a product or service see it quite differently has also been verified through motivation research. In a study of air travel, for instance, several categories of passengers were identified and their images of air travel determined. For the inexperienced air traveler, the flight was a glamorous adventure. For the businessman traveling frequently, air travel meant good schedules, dependability, and excellent service. For the vacationer, air travel was a source of fun. The same study revealed that different airlines varied in their attractiveness for each group, and that no one line was equally attractive to all groups.<sup>25</sup>

<sup>23</sup> Woods, *op. cit.*, p. 19.

<sup>24</sup> M. Haire, "Projective Techniques in Marketing Research," *The Journal of Marketing*, Vol. 14, No. 5 (April 1950), pp. 649-656.

<sup>25</sup> P. Martineau, "The Public Image—Motivational Analysis for Long-Range Merchandising Strategy," *The Frontiers of Marketing Thought and Science* (Chicago: American Marketing Association, 1957), pp. 11-21.

**Brand Image**

The brand image, another stereotype, results from all the impressions consumers receive, from whatever sources, about a particular manufacturer's brand of product. These impressions may be derived from actual experience with the brand, hearsay about it, the company manufacturing it, the packaging, the brand name, the tone, format and content of the advertising presentation, and the specific media in which its advertising has appeared.<sup>26</sup> In the minds of consumers who are familiar with a particular brand, there tends to be considerable consistency in the brand image or, as it is sometimes called, the "brand personality." But for competing brands of a product, there are usually, in the minds of consumers, distinctive images for each brand. Similar statements hold for companies and institutions—retail stores exhibit quite distinct images or personalities and the same is true of corporations with their differences in corporate images.<sup>27</sup> Even airlines possess their own images—the public mind may characterize one as "friendly and folksy," another as "glamorous and adventurous," and still another as "business-like and dependable."<sup>28</sup>

Every brand image is partially derived from a product image. The product image relates to the fundamental aims and satisfactions, both practical and symbolic, which individuals seek or find in a particular area of consumption. The brand image relates to the configuration of ideas, feelings, and meanings which consumers attach to specific versions of the product image.<sup>29</sup>

Consumers' appraisal of the distinctiveness of a brand's physical attributes not only affects the brand image but has important implications for marketing strategy. When consumers believe the brand to be physically different from competing brands, the brand image centers on the brand as a specific version of the product. In this instance, depending on whether the manufacturer considers the image favorable or unfavorable, physical attributes of the product may be retained or changed, and marketing strategy may be directed toward reinforcing or altering the image. On the other hand, when consumers believe that a brand does not have

<sup>26</sup> Herzog, *op. cit.*, p. 37.

<sup>27</sup> For a stimulating discussion of the corporate image, see: P. Martineau, "Sharper Focus for the Corporate Image," *Harvard Business Review*, Vol. 36, No. 6 (November-December 1958), pp. 49-58.

<sup>28</sup> P. Martineau, "The Public Image—Motivational Analysis for Long-Range Merchandising Strategy," *op. cit.*, pp. 11-12.

<sup>29</sup> B. B. Gardner, "Qualitative Research and Brand Image," in R. M. Hill (Ed.), *Marketing Concepts in Changing Times* (Chicago: American Marketing Association, 1960), pp. 59-60.

differentiating physical attributes, the brand image may be associated with the personalities of the people who are thought to buy it. One writer suggests that the manufacturer of such a product, who seeks growth through an increasing share of the market, can follow three alternative marketing paths: (1) try to associate his brand with the public image that is desired or will be desired by most people, (2) try to give his brand several different images so that he can cover the widest segment of the market, or (3) adopt multiple brands, each of which is strongly identified with a public image desired by a significant segment of the market.<sup>30</sup> The role of brand images in marketing, then, reaches its height when competing brands are very much alike, for it is in these instances that the marketer, through advertising, merchandising, and packaging, seeks to build a personality for the brand that will fit the psychological needs of potential customers.<sup>31</sup>

Through the long-continued use of particular advertising and selling appeals, many brands have acquired definite images. In numerous cases, a brand image developed without the management intending it. Whether or not a particular brand image was shaped deliberately, management is well-advised to identify its nature precisely and carefully. Otherwise, ignorance of the brand image may result in poorly planned promotional programs. For example, if the image is a favorable one, the use of inconsistent sales and advertising appeals is likely to be ineffective and may even confuse or alienate existing customers.

Similarly, before introducing a new brand to the market or an established brand to a different market, management should determine the sort of image it wishes to build. Take, for example, the case of Marlboro cigarettes. When the market for filter cigarettes began growing rapidly in the early 1950's, as a side-effect of the "cancer scare," Marlboro was already an established brand of filter cigarettes. However, up to that time the filter market had been composed primarily of women, and Marlboro definitely had a strong feminine image. Philip Morris, Inc., owner of the Marlboro brand, undertook a long-range program designed to provide the brand with a masculine image. Such devices as "the rugged male with a tattoo" were used in Marlboro advertisements in the effort to tap the huge new market of male filter smokers. Such campaigns to alter a brand image must be carefully planned and executed. If they are not, the present market for the brand may be lost without making so much as a dent on the intended market.

<sup>30</sup> G. H. Brown, "Brand Images Among Low Priced Cars," in R. M. Hill (Ed.), *op. cit.*, p. 61.

<sup>31</sup> A. Koponen, "Psychological Response Patterns of Consumers," in R. L. Clewett (Ed.), *op. cit.*, p. 319.

## CONSUMER MOTIVES

Early in the study of consumer motivation, both psychologists and marketing scholars assembled lists of buying motives.<sup>32</sup> In the early 1920's, Professor Melvin T. Copeland, a pioneer marketing teacher, prepared two such lists. Distinguishing ultimate consumers from industrial users, Copeland maintained that two different sets of buying motives were applicable because of the wide difference in the buying procedures of the two groups.<sup>33</sup> In preparing his lists, Copeland analyzed advertisements which appeared in consumer magazines and business journals. Other scholars prepared lists on the basis of interviews with consumers and users. Both research methods were subject to criticism. Copeland's method assumed that advertisers really knew which appeals were most effective and used them accordingly. The interview methods, which generally were of the direct question-and-answer variety, assumed that consumers were aware of their motives and able to verbalize them. In the light of later research, these are questionable assumptions. Furthermore, there is considerable disagreement as to the items included on such lists. One writer explains this lack of agreement as follows: <sup>34</sup>

...when we try to classify motives, we run into all sorts of difficulties. Actually, every social situation is different from every other and requires a separate analysis. This means that there is no such thing as a universal set of explanatory motives. Any list of motives can be classified under a number of different headings; and then someone else can rearrange that same list and assign them to different headings.

*Gratification of Basic Needs*

Psychological studies indicate that human activity, including buying behavior, is directed toward satisfaction of certain basic needs. Not every

<sup>32</sup> For an idea of the variety and coverage of such lists, see the summary of nine different lists in: M. P. McNair and H. L. Hansen, *Readings in Marketing* (New York: McGraw-Hill, 1949), pp. 58-61.

<sup>33</sup> Copeland further divided his list of consumer buying motives into two categories—*emotional* and *rational*:

*Emotional Buying Motives.* Distinctiveness, emulation, economical emulation, pride of personal appearance, pride in appearance of property, social achievement, proficiency, expression of artistic taste, happy selection of gifts, ambition, romantic instinct, maintaining and preserving health, cleanliness, proper care of children, satisfaction of the appetite, pleasing the sense of taste, securing personal comfort, alleviation of laborious tasks, security from danger, pleasure of recreation, entertainment, obtaining opportunity for greater leisure, securing home comfort.

*Rational Buying Motives.* Handiness, efficiency in operation or use, dependability in use, dependability in quality, reliability of auxiliary service, durability, enhancement of earnings, enhancing productivity of property, economy in use, economy in purchase.

Source: M. T. Copeland, *Principles of Merchandising* (Chicago and New York: A. W. Shaw Company, 1924), p. 160.

<sup>34</sup> S. H. Britt, "The Strategy of Consumer Motivation," *The Journal of Marketing*, Vol. 14, No. 5 (April 1950), p. 667.

individual acts in the same way in his effort to fulfill these needs; the actions of each depend upon the nature of the needs themselves, but are modified by his particular environmental and social background. The motivation for any specific action derives from the tensions built up to satisfy basic needs, and frequently some of these needs are beneath the threshold of consciousness. Whatever action is taken is directed toward reducing these tensions.

Although clinical psychologists have not agreed on a single list of basic needs, the different lists available show more agreement than disagreement in the basic needs they suggest. In one list, Maslow enumerates basic needs in their order of importance for most people. According to Maslow, an individual normally tries to satisfy the most basic needs first and, satisfying these, he is then free to devote his attention to the next one shown in the list. The Maslow list is presented below:<sup>35</sup>

1. *The Physiological Needs.* This group includes hunger, thirst, sleep, and so forth. These are the most basic needs, and until they are satisfied, other needs are of no importance.
2. *The Safety Needs.* In modern society these needs are more often reflected in the needs for economic and social security rather than in needs for physical safety.
3. *The Belongingness and Love Needs.* The need for affectionate relations with individuals and a place in society is so important that its lack is a common cause of maladjustment.
4. *The Esteem Needs.* People need both self-esteem, a high evaluation of self, and the esteem of others in our society. Fulfillment of these needs provides a feeling of self-confidence and usefulness to the world; failure to fulfill these needs produces feelings of inferiority and helplessness.
5. *The Need for Self-Actualization.* This is the desire to achieve to the maximum of one's capabilities and, although it may be present in everyone, its fulfillment depends upon the prior fulfillment of the more basic needs.
6. *The Desire to Know and Understand.* These needs refer to the process of searching for meaning in the things around us.
7. *The Aesthetic Needs.* These needs may not appear to be present among many individuals because of their failure to satisfy more basic needs, but among some individuals the need for beauty is an important one.

Very often, the marketing success of a brand depends on its ability to satisfy several needs at once; and now that motivation research techniques are available with which to identify the strength or weakness of a product in terms of the needs it fulfills, the concept of basic needs and

<sup>35</sup> A. H. Maslow, *Motivation and Personality* (New York: Harper and Brothers, 1954), pp. 80-85.

the theory that individuals normally try to satisfy them in some order are especially significant to marketing.

#### *Motivations of Ultimate Consumers versus Industrial Users*

Much has been written concerning differences in the buying motivations of ultimate consumers and industrial users. Generally, it is concluded that ultimate consumers are emotional buyers, and that they are motivated more strongly by emotional than by rational considerations. Generally, too, industrial users have been portrayed as essentially rational buyers. The concept of need gratification renders meaningless the dual classification of motives as rational or emotional. Under this classification system, an individual attempting only to fulfill the most basic needs is influenced solely by motives classed as rational. A person at the level of bare subsistence wants the most for his money in terms of quantity, quality, and dependability. But most Americans live far above the subsistence level, and the majority of their purchases are directed toward fulfilling other of the basic needs. Distinctiveness, emulation, and pride in personal appearance (allegedly emotional buying motives) may be perfectly rational means of fulfilling belongingness or esteem needs. In this sense, it might be claimed that all consumer buying motives are rational. However, certain motives are generally agreed to be more rational than others and, since man thinks of himself as a rational creature, people tend to rationalize and express their motives in the most rational way possible. Earlier we referred to this tendency as rationalization and another example now may assist in clarifying that concept. The buyer of an expensive automobile may explain that the high price is justified in terms of greater durability and better trade-in value, but he may have actually made the purchase to fulfill esteem needs. Often, these esteem needs may be totally beneath the threshold of consciousness, and the buyer of the high-priced auto may honestly believe that his buying motives were "rational."

Industrial users tend to be more "rational" in their buying than ultimate consumers. Industrial users buy to fill the needs of their organizations, and these needs normally are of a very practical nature. But it should not be forgotten that organizations are composed of individuals, that one or more individuals in these organizations do the buying, and that these individuals have personal needs which sometimes become enmeshed with their roles as buyers. Thus, even industrial purchases may be made on irrational, or emotional, bases, as in the case of the purchasing agent who buys from a certain supplier because the salesman is his good friend.

### CONCLUSION

In using the fruits of psychological research to explain consumer motivation, the marketing man must start with the thesis that consumer behavior is but a special case of human behavior in general. The psychological factors influencing individual action are also operative when that individual is acting as a consumer. In order to understand the psychological aspects of consumer motivation, the marketer needs to be acquainted with the underlying psychological theory. The chief purpose of this chapter has been to provide this background.

### QUESTIONS AND PROBLEMS

1. Why do you suppose many advertisers have relied primarily on repetition to achieve customer recognition of their products, when learning is more easily achieved with proper motivation?
2. Would you say that many consumers have become conditioned to "shut out" (not see or hear) all advertising to which they are exposed? What are the implications for advertisers?
3. Would it be fair to say that when a conscious and an unconscious motive conflict, the conscious motive will dominate?
4. Through rationalization, the consumer finds a "sensible" or "reasonable" excuse for actions motivated by "frivolous" reasons. What is the implication for marketing?
5. Does the concept of projection help in motivating the consumer, or only in learning what motivates him?
6. Give some examples how the self-image of a bank teller and a taxi driver might lead them to act differently as consumers, assuming equal incomes.
7. Would the same consumer fall into the same one of the six psychological market segments, described by W. A. Woods in his consumption patterns, for all products?
8. Do you think it would be easier to sell products with high ego-involvement or with none at all? Why?
9. Is it likely that we can generalize to other products from the experience with instant coffee in the Mason Haire study? Give some examples that occur to you.
10. Once a brand image has developed in the minds of the public, there is little that can be done to change it. Comment on this statement.



11. In order to develop distinctive brand images, there must be clearly identifiable physical differences in the products involved. Do you agree?
12. Would you agree that any attempt to classify consumer buying motives as emotional or rational is unrealistic and purely of historical interest today?
13. Does the failure of psychologists to agree on a common list of basic needs destroy the concepts of such needs as a marketing tool?
14. Under Maslow's classification of basic needs, different individuals have achieved different levels in satisfying their needs. Does this imply that it would be necessary to appeal to different needs to sell the same product to different people?
15. If all motives are claimed to be rational, how can some motives be more rational than others?

S O C I O L O G I C A L

F A C T O R S

A F F E C T I N G

C O N S U M E R

D E M A N D

# 9

Traditionally, consumer motivation has been expressed only as a function of economic and psychological factors. Classical economists explained consumer motivation in terms of financial self-interest. "Economic man" could be expected to act rationally with the goal of maximizing his financial gains. This interpretation of consumer motivation has continued as a foundation of economic theory into modern times. But this explanation provides little comfort to businessmen who, actually dealing with consumers, are confronted daily with instances of apparently irrational consumer behavior. For a more satisfactory explanation of consumer motivation, business-

men next turned to the field of psychology. Psychologists have attempted to explain the actions of individuals in terms of basic wants or needs common to all people. Although psychological explanations of human motivation have been helpful, there are still, from the standpoint of businessmen, fuzzy areas where there are no satisfactory answers. For example, the psychologist explains that people are sometimes motivated by the desire to emulate others, but he does not provide a satisfactory explanation as to whom a particular individual or group of individuals may wish to emulate. To answer this question, we must turn to the field of sociology, the science that studies human society and the actions and reactions of the individual as a member of a group or groups. Sociologists view marketing as the activities of groups of people who are motivated by group pressures as well as by individual desires.

Thorstein Veblen, an economist, in discussing conspicuous consumption, was among the first to use sociological factors to explain consumer motivation.<sup>1</sup> But, only since World War II has business made extensive use of the skills of sociologists and anthropologists in the effort to explain the actions of the consumer.<sup>2</sup> Motivation research, a rapidly developing field whose findings are of great interest to businessmen, makes use of the skills and techniques of both sociologists and psychologists to explain consumer motivation. Recent studies have pointed up the significance of the social group, the individual's concept of social role, and social class as influences on human behavior. These studies have demonstrated the importance of social factors in evaluating and influencing the consumer, but such studies often leave the businessman with the uncomfortable feeling that he must consider numerous concepts he does not really understand. The average businessman has had little or no formal training in sociology and, although sociologists do considerable research for business, little has been done to express sociological concepts in terms familiar to the business executive. Consequently, he frequently finds himself in the position of trying to converse in a strange language without even having a dictionary. Since the field of sociology has contributed information valuable in explaining consumer motivation, it is appropriate to examine the basic sociological concepts underlying these contributions.<sup>3</sup>

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<sup>1</sup> Veblen, Thorstein, *The Theory of the Leisure Class* (New York: The Modern Library, 1934).

<sup>2</sup> For an unusually clear and interesting discussion of the importance to business of using the services of sociologists and other behavioral scientists, together with the accompanying problems and pitfalls, see: J. W. Newman, "Working with Behavioral Scientists," *Harvard Business Review* (Vol. 36, No. 4), July-August 1958, pp. 67-74.

<sup>3</sup> For two interesting articles relating and comparing the fields of sociology and marketing, see: C. T. Jonaassen, "Contributions of Sociology to Marketing," and R. Bartels, "Sociologists and Marketologists," *Journal of Marketing*, Vol. 24, No. 2 (October 1959), pp. 29-35, 37-40.

### THE INDIVIDUAL AND SOCIETY

The individual cannot be separated from the society in which he lives. Although all people have certain biological needs in common, these are strongly modified by the cultural environment and, hence, affect ultimate behavior. All people need to eat, but what they eat and how they eat is, to a great degree, determined by the behavior patterns of their society. To the average American, the thought of eating dog meat is repugnant. This is not because of any belief that dogs are inedible; the eating of dog meat just happens to be socially unacceptable. How are these social customs established, and who determines what is acceptable or unacceptable?

#### Primary Groups

The primary group, fundamental in determining the social nature of the individual, may be defined as a group of people involved in intimate, face-to-face contact and cooperation. The most pervasive and probably most influential group is the family. In the traditional large-family setting, where several generations lived under one roof, this group greatly influenced the socialization of the child. With the emergence of the modern, small, two-generation family, much of this influence has passed to other primary groups, particularly to the peer groups. Peer groups are made up of individuals who spend considerable time together, and are of fairly common age and social background. Among children these are often called play groups; among adults they include neighborhood and community groups. David Riesman, in *The Lonely Crowd*,<sup>4</sup> attributes tremendous influence to these groups among the urban middle classes, where the numbers of people are large enough to form highly homogeneous peer groups. Other groups which have varying degrees of socializing influence are work groups and religious, educational, and political institutions.

Each individual may be a member of several different primary groups. As a member of a religious institution, he may or may not have close personal contacts with other members. At work he may be part of a close-knit, friendly group of co-workers. As a member of social or fraternal organizations, he may be a part of still other primary groups. Any of these groups might be classified as peer groups if they are sufficiently homogeneous. Purely social groups are most likely to fall into this category. The peer group has the greatest influence on the individual in his general role as a consumer since the general interests and mode of life of this group are most nearly like his own.

The way a person sees his role in the social groups of which he is a mem-

<sup>4</sup> Riesman, Glazer, and Denney, *The Lonely Crowd* (New Haven: Yale University Press, 1950).

ber is an important factor in explaining his motivation. If he is a "rugged individualist," he may enjoy establishing a reputation as one who sets his own patterns of behavior—within established group norms of good conduct. Individualism was a commonly accepted mode of behavior in the nineteenth century in the United States, but a different type of group behavior has evolved and become important since then. This newer mode of behavior requires fairly close conformity to group norms. The group-oriented individual is anxious to fit into the behavior patterns of his peers. What they do, he must do. This does not imply, however, that his pattern of behavior is frozen. Since group norms may change at frequent intervals, he may find it necessary to adjust his own behavior to reflect these changes. The group-oriented individual is seldom motivated by the traditional appeals of "being an innovator" or "leading the pack." If he is to be motivated to action, he must first be persuaded that the suggested action is accepted by his peers as the proper thing to do.

#### *Influence of the Masses*

As differentiated from primitive societies, modern American society is a mass society comprising great numbers of people spread over a wide geographical area, not personally known to each other, and with heterogeneous interests. In addition, the mass is not an organized group and does not necessarily share common customs and traditions. It does not think or act as a group (as would a mob), although it does tend to climb on the bandwagon of public opinion after a clear majority opinion has been registered. (This is probably the reason why it is difficult to find people willing to admit that they voted for a badly defeated political candidate.) The mass is also characterized by instability of interests; today's hero may be forgotten tomorrow. This, then, is the human aggregation that is reached by our mass media.

A businessman attempting to communicate with these masses through mass advertising must first understand the characteristics of this amorphous group. The term "mass market" may be misleading. The mass market is made up of individuals, each making separate buying decisions. These decisions may be strongly influenced by actions of other members of the primary group, but only rarely are they affected by the actions of the masses as such. Only on rare occasion does a product achieve true mass acceptance and, when it does, the fickleness of the mass almost surely dooms it to a short-lived success. Such was the case with the hula hoop.<sup>5</sup> The product that is successfully promoted through the mass media is not really marketed to the mass audience as a unit. Instead, it is really

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<sup>5</sup> The hula hoop fad, which occurred in 1958, started in May in southern California. By the close of September the fad had spread from coast to coast and from border to border but was almost dead. The Toy News Bureau, a publicity organization of toy

promoted simultaneously to many individual members of similar homogeneous primary groups throughout the market.

### **SOCIAL STRATIFICATION AND CLASSES**

Every society classifies its members according to some social hierarchy. In all societies there are people who occupy positions of relatively higher status and power. In modern American society, class lines are not finely drawn, and it is next to impossible to identify a specific number of classes into which all individuals can be grouped. In medieval European society, there were clear demarcations among the nobility, merchants, and peasants, and very little mobility between classes. In a highly mobile society such as ours, where class lines are not finely drawn, some standards or criteria that can be used to rank individuals must be found.

#### *Criteria for Ranking Individuals*

The most important criterion of class status is occupation. If a single standard were to be used, occupational status would most accurately describe class differences in the United States. To many people, occupational status is synonymous with class, the class groups commonly described as the laboring class, the white-collar class, and the managerial class. The occupation of the individual presents a clear picture of his personal achievements and his contributions to society.

Occupations are ranked according to several standards: First are the qualifications necessary for success in the occupation, such as training, education, and intelligence. These help to explain the rankings given various occupations, but they do not explain all situations. Certain political jobs, for example, almost reverse the normal pattern. An advanced university degree is often said to be the "kiss of death" to an aspiring politician. Second is the financial reward attaching to the job. In most instances, financial reward is closely correlated with education, training, and experience, but here also are exceptions as in the ministry and public service. These exceptions must be explained by additional factors, one of which is the honorable status attached to the job. The minister and professor receive "psychic income" from the recognition on their own parts and by others of their contributions to society. Third are the working conditions which characterize the job for, in the mind of the general public, differences in working conditions have always separated the ditch digger and the plumber from the white-collar worker. Collectively, these

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manufacturers, estimated that more than 25 million hoops were sold during this short span of time. One company, Wham-O Manufacturing Company of San Gabriel, California, among the first to manufacture hoops, claimed that it alone had sold upwards of ten million. An executive of Maison Blanche, a New Orleans department store, estimated that nearly two million hoops had been sold in that city alone. See: *Wall Street Journal*, October 28, 1958, pp. 1, 15.

three factors measure what might be called occupational prestige. The literature of sociology contains reports of a number of studies which have attempted to measure the prestige rankings of a large number of occupations. As might be expected, managerial and professional occupations rank at the top, and low-pay, low-skill occupations at the bottom.

A second criterion of class status, wealth and income, is closely related to the first. It has already been mentioned that financial reward is an important factor in the ranking of occupations. There are, however, instances where wealth and income provide an entirely independent measure of class status. One instance is that of inherited wealth. Although the enactment of highly graduated inheritance taxes has reduced the importance of this factor, it is still influential. For instance, W. Lloyd Warner, in attempting to classify American society into six broad classes, differentiates between the top two classes primarily on the basis of old family and inherited wealth as compared with the "nouveau riche."<sup>6</sup> A second case where wealth and income are not closely related to occupation is in the family with more than one wage earner. A skilled laborer with a working wife or working dependent children may have a larger family income than many managerial or professional families. The gradual deterioration (in some cases even the reversal) of the traditional relationship between the incomes of white-collar workers and laborers has increased the difficulty of clearing defining class lines.

Possessions are the normal measure of wealth and income. Thus, a wealthy miser with few worldly possessions would occupy, in the eyes of the average individual, lower class status than his capital assets might imply. With the progressive reduction in extremes of income, possessions have become a more satisfactory measure of class status than income and wealth. This is of particular significance to the businessman whose products or services are sold to ultimate consumers. Sociological studies have uncovered differences in spending and buying patterns among different social classes, even when family income is the same. For example, lower class and middle class families express markedly different preferences in home furnishings, differences which cannot be explained solely in terms of prices. The social and class status attached to various makes and models of automobiles also varies widely. The aura of successful achievement that has come to be so strongly associated with the ownership of a Cadillac may lead a socially ambitious individual to buy that make in preference to an equally expensive Imperial or Continental.<sup>7</sup>

A third criterion of class status is family. This tends partially to ex-

<sup>6</sup> W. L. Warner and P. S. Lunt, *The Status System of a Modern Community* (New Haven: Yale University Press, 1942), pp. 88-91.

For an interesting description of the ways in which the two top classes may be establishing closer relationships, see: "The Rich Come Out of Hiding," *Business Week*, November 15, 1958, pp. 58-72.

<sup>7</sup> P. D. Martineau, *Motivation in Advertising* (New York: McGraw-Hill, 1937), Ch. 6.

plain the high social status assigned to certain "old families" in parts of New England and the South. However, this factor is far less important now than it was fifty years ago, mainly because family position is no longer as closely related to occupation, income, and wealth. Increased educational opportunity for the underprivileged has narrowed, though definitely not eliminated, the differential in occupational opportunity, and income and inheritance taxes have reduced the magnitude of difference in inherited wealth. Nowadays, it is not difficult for a person who is occupationally and financially successful to move up to a higher class status, except up to the top level. Family position is still important for admission to that rarefied atmosphere. The wife and minor children occupy the same social status as the husband or breadwinner, and a change in social status for one means a change for the entire immediate family. Once a person is on his own, he may occupy a social status different from that of his parents or brothers and sisters.

A fourth criterion of social status, authority and power, is also closely related to occupation and wealth. This is why a school superintendent usually enjoys much higher social status and income than the school teachers in his system, although their education may be equivalent. A fifth criterion, personality, is perhaps of most significance to the socially mobile individual who is moving up in the social strata. The person with a flexible and attractive personality adapts far more easily to the customs and usages of a higher social class.

#### *The Social Class Structure of the United States*

Most sociologists have classified American society into three broad, roughly defined classes: the upper, middle, and lower classes. One sociologist, however, W. Lloyd Warner, on the basis of studies in three American towns, set up a hierarchy of *six* American social classes: upper upper, lower upper, upper middle, lower middle, upper lower, and lower lower.<sup>8</sup> This classification has had considerable publicity, but many sociologists believe that it is more precise than accurate. Under Warner's classification, the class status of each person is ascertained by asking his fellow citizens (his equals, his superiors, and his inferiors) to rank him. It is how each of these groups looks at him that indicates his actual status. This dependence on the ratings of fellow citizens has been the main cause for criticism of the Warner system. The ordinary citizen does not think in terms of this complex hierarchy and, when asked to classify his fellow citizens into the six groups, shows little agreement with others who are asked to do the same thing. Perhaps the most important single rating is the willingness of that group of people whom he considers his equals to accept him as *their* equal.

<sup>8</sup> W. L. Warner and P. S. Lunt, *op. cit.*, pp. 88-91.



The so-called status-symbol school of sociologists provides an interesting explanation of how the twin urges for self-expression and self-betterment, shared by nearly all Americans, take the form of aspiring to higher status. This school holds that (1) people express their personalities not so much in words as in symbols (e.g., mannerisms, dress, ornaments, possessions); and (2) most people are increasingly concerned about their social status. Different products vary as to their status-symbol value, and their value may also change; the automobile was once the major status symbol, but many sociologists maintain that it has now been replaced by the house and its furnishings.<sup>9</sup> The status symbol concept is one the marketer does well to consider, for when he understands that he is selling a symbol as well as a product, he is able to view his product more completely. He should understand not only how his product satisfies certain practical needs but also how it fits meaningfully into modern culture. When the marketer has this understanding, both he and the consumer stand to profit.<sup>10</sup>

American society has no single elite or ruling class; it has *several* elites. Among others, there are the management elite, the professional elite, the political elite, and the "old family" social elite.<sup>11</sup> There is no clear-cut line between the elite or upper class and the upper middle class business and professional men. But there does seem to be one factor that differentiates the upper middle class from the lower middle class—educational expectation. In the upper middle class family, it is usually taken for granted that the children will receive a college education, whereas in the lower middle class family such an expectation is not the rule. Traditionally, the distinction between the middle and lower classes in the United States has been based on income differences and has remained fairly stable. White-collar workers and small entrepreneurs with their higher incomes made up the middle class, and laborers and farmers with their lower incomes made up the lower class. This distinction has blurred with the new high incomes earned by elite labor and the deteriorating relative income of white-collar workers.<sup>12</sup>

### Social Mobility

There is in the United States a long-standing belief in the democratic principle of equal opportunity for all. Our history is full of instances where men moved up from the humblest beginnings to positions of the highest

<sup>9</sup> G. Burck, "How American Taste is Changing," *Fortune*, July 1959, pp. 186-188.

<sup>10</sup> S. J. Levy, "Symbols for Sale," *Harvard Business Review*, Vol. 37, No. 4 (July-August, 1959), p. 124.

<sup>11</sup> For a highly interesting account and analysis of the different elites in American society, see: C. W. Mills, *The Power Elite* (New York: Oxford University Press, 1957).

<sup>12</sup> For an illuminating treatment of the blurring of class distinctions, see: D. Seligman, "The New Masses," *Fortune*, May 1959, pp. 106-111, 257-258.

importance. Abraham Lincoln, of course, is an outstanding example and, without question, our society has been highly mobile in comparison with other societies. (The results of a few sociological studies would indicate that this mobility has all but disappeared. Critics have pointed out, however, that these studies were made in small towns from which the more-able young people tend to emigrate, so little mobility was to be expected from those who remained.<sup>13</sup>)

The fact that each social group has a reference group helps explain upward mobility or, as it is popularly known, "social climbing." The reference group of the lower class is the middle class; the reference group of the middle class is the upper middle class; the reference group of the upper middle class is the upper class; and the reference group of the American upper class is the British upper class. Each social group has its own behavior patterns, values, and attitudes, but these are conditioned subconsciously by its reference group. Some social groups are happy and secure in this situation, some are not.<sup>14</sup>

There seems still to be strong evidence that social mobility is high in the United States, although at different rates for each class. Mobility upward from the lower class is low because there is much stronger motivation for achievement in middle and upper class people and, hence, higher mobility aspirations. In contrast to the middle class, the lower class seeks job security and avoids risk, expresses more limited income expectations, places less value on education (and plans for less), and plans for lower occupational goals.<sup>15</sup> Perhaps the most important change in the lower class is the shift from a success goal to a security goal. Many lower class people have exchanged the old American goal of "office boy to President" for social security and a pension. They would prefer to settle for the safety of a routine job rather than the risks that accompany ambition. In addition, many lower class people have become more interested in the pursuit of leisure and enjoyment than in success. Promotion and success come to the men who spend many overtime hours on their jobs, but to many men the loss of enjoyable hours for sport and recreation is too great a price to pay for the remote possibility of promotion. At the same time, there is a trend toward there being fewer people in the American lower class. Declines in the numbers of drudgery type jobs, and the financial

<sup>13</sup> For both viewpoints, see: R. S. Lynd and H. M. Lynd, *Middletown in Transition* (New York: Harcourt, Brace, 1937), pp. 70-72; W. L. Warner, R. J. Havighurst, and M. B. Loeb, *Who Shall Be Educated?* (New York: Harper & Brothers, 1944); and G. Sjöberg, "Are Social Classes in America Becoming More Rigid?" *American Sociological Review*, Vol. 16, pp. 775-783.

<sup>14</sup> M. C. Pirie, "An Anthropologist Looks at Marketing," in F. E. May (Ed.), *Increasing Sales Efficiency*, Michigan Business Papers No. 35 (Ann Arbor: Bureau of Business Research, University of Michigan, 1959), p. 153.

<sup>15</sup> L. Reissman, "Levels of Aspiration and Social Class," *American Sociological Review*, Vol. 18, pp. 233-242.

and prestige upgrading of many skilled laboring jobs, have effectively decreased the membership in the lower class and increased that in the middle class.

### **PATTERNS OF AMERICAN CULTURE**

Every culture evolves unique patterns of social conduct, and the study of these patterns is important to the marketer since it helps him explain and predict the actions of the individual as a consumer. Many aspects of the American culture are unique in an anthropological or sociological sense. These differences include the roles of ethnic and racial groups, religion, women in the society, leisure time, fashion and acceptance of change, and population movements.

#### ***Ethnic and Racial Groups***

The United States has been described as a melting pot of cultures and national groups, but this blending of peoples and cultures has not been complete. And, although an identifiable American national culture *has* emerged, it has not equally permeated all portions of society or all geographic regions. In parts of the American southwest, for example, a Spanish or Mexican influence is still noticeable; in Minnesota, in the states surrounding it, and in the Puget Sound area, a Scandinavian flavor is still apparent. These areas of foreign ethnic flavor are found in various parts of the country and in clearly definable neighborhoods in cities. Although these ethnic differences have tended to decrease with each succeeding generation, their continuing existence helps to explain certain differences in consumer motivation and behavior that would not exist in a nation of people with a common cultural heritage. There has also been a tendency for the United States to evolve as a multi-racial society with different patterns of social behavior in each racial group. These ethnic and racial factors contribute to the segmentation of the American market.

#### ***Religion***

American society has a basically Judaeo-Christian religious heritage, and this has shaped its cultural development. Whereas some religions stress passive acceptance of life and man's role, the Christian and Jewish religions emphasize the perfectability of man and his environment and, hence, encourage him to improve himself and his way of life. Therefore, the production and consumption of goods are acceptable activities because they contribute to the welfare of society. Within the American Judaeo-Christian religious pattern there are many individual sects and creeds, and, although they share similar feelings about the overall roles of production and consumption in society, the patterns of consumption of selected foods, beverages, and apparel vary among these religious groups.

Thus, the diversity of religious creeds in the United States contributes to the diversity of the market.

### *The Role of Women*

The role of women in American society has undergone considerable change. A continuing movement towards full equality of legal rights and social privileges has broadened women's opportunity for participating in economic and political activities. Approximately one-third of adult American women are employed in the work force and have incomes of their own to spend; labor-saving appliances are providing the remaining two-thirds with more time free from domestic responsibilities, and, consequently, more time for family shopping. In general, too, they are better educated and better informed than were their mothers and grandmothers. The result is that American women have either sole or major responsibility for buying many kinds of goods and are exerting an increasing amount of influence on buying decisions of all kinds. The information in Table 9.1 provides some insights on the relative influence exerted on purchase decisions by husband and wife. These data were compiled from a two-and-one-half year study of a cross-section of families in all parts of the United States. Interviews were obtained from both husbands and wives. Notice that among the decision areas studied, one—car purchases—is attributed to husbands primarily, while another—purchases of household goods and furniture—was thought to be controlled by wives more often than by husbands. It is quite possible that there are other "husband-dominated" areas which were not studied, such as home repairs and gardening equipment, and there may be other "wife-dominated" areas such as interior decorating, rugs, and draperies.<sup>16</sup> Both husbands and wives were asked the same questions, and their answers were tallied separately under columns "A" and "B" in Table 9.1. It is interesting to note that, with only one important exception, husbands and wives were in very close agreement as to who makes family decisions. In decisions on money and bills, six per cent more women than men believed that this was entirely or predominantly the wife's decision, while five per cent more men than women believed that this responsibility was shared equally.

### *Leisure Time*

During the past half century in the United States, the length of the normal working week has been reduced from as much as 84 hours in the steel industry to an average of somewhere around 40 hours. As a consequence, the average worker has gained considerable free time to use at his own discretion. This discretionary time has been increased even more for the

<sup>16</sup> E. H. Wolgast, "Do Husbands or Wives Make the Purchasing Decisions?" *The Journal of Marketing*, Vol. 23, No. 2 (October 1958), p. 153.

**Table 9.1**  
Husbands' and Wives' Reports  
Regarding Decision-Making Patterns

*Who in Your Family Decides?*

	When it's time to buy a car		About savings		Money and bills (from a nonpanel study)		When it's time to buy household goods, appliances, furniture, etc.	
	Husbands A	Wives B	Husbands A	Wives B	Husbands A	Wives B	Husbands A	Wives B
Wife only	3%	3%	27%	26%	39%	43%	24%	25%
Wife predominantly	1	1	2	6	b	2	12	10
Both equally	31	23	47	49	31	26	53	51
Husband predominantly	5	9	3	4	2	2	4	5
Husband only	51	54	18	13	27	27	4	6
Don't buy (don't save)	7	9	3	2	b	b	2	2
Not ascertained	2	1	a	a	1	—	1	1
Number of cases	354	297	343	301	454	505	354	307

a. "Not ascertained's" were excluded here.

b. Less than 0.5%.

Sources: E. H. Wolfgang, "Do Husbands or Wives Make the Purchasing Decisions," *The Journal of Marketing*, Vol. 23, No. 3 (October 1958), p. 153.

average citizen through the advent and spread of paid vacations, since many families could never afford to take vacations without pay.

The economic concept of "opportunity cost" is helpful in explaining the continuing trend toward more free time for more people. Essentially, this explanation boils down to the proposition that as economic productivity rises, the opportunity to choose between work and leisure rises with it. One authority on the subject of leisure states the argument this way:<sup>17</sup>

The value of free time to the worker is in a sense set by what economists might call its "opportunity cost"; that is, free hours are chosen by the wage- or salary-earner because they are worth more to him than the opportunity to raise the country's output and thus indirectly make available to him a larger volume of goods. The opportunity cost of leisure rises as *standards of living* rise. If a worker of today were content with the goods and services which would have seemed sufficient to a worker of a hundred years ago, he might have much more free time than he has. To earn ample food, comfortable clothing, and a roof over his head would not require nearly as long hours as are now prevalent. But wants for purchasable goods have risen as productivity has risen. Prevalent standards of living include, among other things, automobiles, radios and television sets, mechanical refrigerators, washers, vacuum cleaners, longer dependency of children as they spend more years at school, more medical services, unemployment insurance, old-age pensions, and the multifarious tax supported services of government. From time to time philosophically minded persons object that such embellishments of living are not worth what they cost. For this point of view, expressed more than a hundred years ago, the classic American argument is Henry David Thoreau's *Walden*. In an economic sense, *Walden* might be called a plea for reduction of the opportunity cost of leisure.

The growing amount of leisure time has had a profound effect on markets and marketing. The "do-it-yourself" market is an excellent example. The man or woman who has some free time gets pleasure out of making or repairing items he or she would have formerly purchased or paid to have fixed. This not only provides the psychic satisfaction of creative activity, but alleviates any feeling of guilt about nonproductive use of time.<sup>18</sup> Consequently, some businesses have reorganized their distribution systems with a view toward making their products more readily available to these "do-it-yourselfers." Americans now have more time for travel and cultural pursuits. The booming tourist industry and the increased interest in art, music, and books are some of the results.

Perhaps the most important effect of increased leisure is reflected in

<sup>17</sup> G. Soule, "The Economics of Leisure," *The Annals of the American Academy of Political and Social Science*, September 1957, pp. 20-21.

<sup>18</sup> American culture has been strongly affected by the social values of the early colonists. Religious leaders, particularly in New England, preached that man was made to work and that laziness was sinful. These beliefs permeated American society so effectively that even present-day Americans feel a little uneasy about nonproductive activity.

changes in values and the "way of life." Instead of buying an expensive car to impress his friends, a consumer may economize on this purchase in order to buy the boat, shop tools, or fishing equipment he wants. New homes are planned in such a way as to simplify participation in leisure time activities. Both the men's and women's clothing industries have experienced an increased demand for informal sports wear. The impact of these changes on business has been enormous. Whole new markets have been opened up and new enterprises have been organized to serve them.

### *Fashion*

Fashion can be defined as the opinion of a group of people about a thing. Since it is a reflection of opinion, and since people like occasional change, it is necessarily transitory. Fashion should be differentiated from style in this respect. A style is a kind of design or art form that is unchanging. When, in the opinion of a large group of people, a particular style is popular, that style becomes a fashion. In turn, if a fashion is of particularly short duration, it is called a fad. Fashion, then, is the pursuit of novelty for its own sake. Every market into which the consumer's fashion sense has insinuated itself is, by that very token, subject to a common, compelling need for unceasing change in the styling of its goods.<sup>19</sup>

The role of fashion in American society has been growing. Because of improving media of communications, including the wide coverage of television and expanding circulations of published media, fashion news is spread far and wide in less time. Accordingly, the time span covered by the appearance of a new fashion, its adoption by a few pace-setters, its rise to popularity, and its subsequent decline has been becoming shorter. In other words, the rate of fashion change has been accelerating. At the same time, expansions in the amount of discretionary income in the hands of consumers have permitted them to spend more in their attempts to satisfy the desire for change. Furthermore, there are increasing numbers of group-oriented people in society, and fewer individualists, and this has lent added importance to conforming to changes in fashion.

A lucid illustration of the powerful influence of fashion was provided by one authority who reported the following: <sup>20</sup>

... fashion is the impulse that opens up new volume opportunities, even in sales-saturated industries. Here's what I mean: Certainly the telephone is so much a part of our lives today that few of us could live without one. Yet A.T.&T. achieved new sales goals *and* product diversification by using fashion to sell extension telephones in the home. True, the extension phone cam-

<sup>19</sup> D. E. Robinson, "Fashion Theory and Product Design," *Harvard Business Review*, Vol. 36, No. 6 (November-December, 1958), p. 127

<sup>20</sup> H. Valentine, "Fashion—Who Needs It?" in *Report on the Twenty-Ninth Boston Conference on Distribution* (Boston: Retail Trade Board, 1957), pp. 32-34.

paign started on a utility and step-saving basis. "Have an extension in your kitchen or have one upstairs in your bedroom. Save energy, save steps." It sounded like a good idea, but it met with definite resistance. Why? Probably because it made a woman feel guilty! Was she too lazy to go a few steps or walk a few stairs to answer her phone?

But what happened when *color* was added to the sales message? Now a woman had a guilt-free, *fashion* reason for installing a couple of "decorator" phones throughout the house. Sales soared! In fact one A.T.&T. executive recently told us that the number of homes with more than one phone has nearly doubled in the past six years. And it was felt that color had a great deal to do with breaking the ice. . . .

### Population Movements

The important population trends in the United States and their impact on markets were described in Chapter 2, and much of this information has been made available through the studies of anthropologists. One particularly important trend is the growth of suburban population and the development of a unique way of life in the suburbs.

Much of the current population growth in metropolitan areas is occurring in the suburbs rather than in the urban areas. This trend is significant to marketing because the suburbanite often represents a very different market from the urbanite. The suburb retains much of the character of a small town. Consumption patterns are strongly affected by neighborhood and local social groups. Sociologists have contributed to an understanding of urban-suburban differences and, thus, facilitated the job of serving each market.

### IMPLICATIONS FOR BUSINESS

Broadly speaking, the social aspects of motivation revolve around self-interest, just as do the economic and psychological aspects. An individual seeks satisfactions that will maintain his own self-respect by fitting into the moral norms established by the society in which he lives. At the same time he seeks recognition and respect from others. He seeks pleasure, not in a biological sense but in terms of what is considered acceptable by the groups with which he identifies, and he also seeks affection and friendship. Sometimes, he may want something not for itself but for the social gain he gets from it. The lady living in Florida who buys a fur piece does not buy it to keep warm but because of what it will do for her social status.

Except in the elite or upper class, there seems to be little individuality among modern American consumers. Conformity seems to be the rule. Of course basic conformity still leaves room for individual differences, but only within limits. The standards to which the individual conforms often change at a bewildering rate, but the middle class consumer, and the lower class consumer to a somewhat lesser degree, are socially obligated to keep



pace with the changes. Fashion in clothing is an excellent example of this.<sup>21</sup> The sack dress became established as a standard of stylish dress in 1958, and, although many women considered the style personally unflattering, they felt compelled to buy them to be fashionable—to conform. Each woman could select from a number of style variations, colors, and fabrics, as long as the garment was a sack. To illustrate the rapidity of these fashion changes, the sack was completely out of fashion within 12 months. This need for conformity affects a broad variety of consumer purchases today.

In a culture such as ours, one evidently committed to the elimination of impassable class lines, few people are wholly satisfied with their existing social status, most striving endlessly to improve their positions. One outcome is that possessions acquired by the individual are uniquely related to his own goals. Personal property is not considered a prerogative of any special group, but rather a measure of success and, hence, a means of achieving higher class status. A clear understanding of this fact is of great importance to the businessman. Although many products carry little or no connotation of status, many others are highly significant in providing a measure of the social position of their owners. Marketing executives at all distribution levels, from the manufacturer to the retailer, should determine the status connotations of their products. Then, merchandising and promotional efforts should be directed to those consumers who are most likely to obtain maximum satisfaction from ownership of the product.

Members of different classes show a wide divergence in interests and activities which, in turn, influence their consumption patterns. For example, a definite relationship exists between the prestige level of occupation and kinds of leisure time activities.<sup>22</sup> Different recreational preferences among the various classes affect their expenditures on hobbies and recreation.

An awareness of the differences between the upper, middle, and lower classes is also important in selecting the mass advertising media to reach them. The upper classes read more books and magazines; the lower classes listen to more radio and view more television; the middle classes lie somewhere in between. Although there are some magazines with a primarily lower-class appeal, only a small proportion of the lower classes are reached through such a medium. Larger audiences of these people are reached through radio and television messages. For the upper classes, the reverse is true.<sup>23</sup> Certain popular television shows reach the upper

<sup>21</sup> R. Bendix and S. M. Lipset, *Class Status and Power* (Glencoe, Ill.: Free Press, 1953), p. 323.

<sup>22</sup> Alfred C. Clarke, "The Use of Leisure and Its Relation to Occupational Prestige," *American Sociological Review*, Vol. 21, pp. 301-307.

<sup>23</sup> J. T. Klapper, *The Effects of Mass Media* (New York: Columbia University Bureau of Applied Social Research, 1949), pp. 1-17.

as well as the middle and lower class markets, but appeals directed solely to the upper class market are usually more effectively conveyed through the so-called class magazines.

These generalizations apply only to the American market. Social factors vary enormously among different peoples and nations, and businessmen who seek business abroad must first study the social environment in each foreign market. The social class structure varies widely even among the most highly developed countries, and other sociological factors vary just as much. For instance, the French woman is much more highly individualistic than the American woman in her selection of clothing. She selects first that which is flattering and only second that which is fashionable.

### CONCLUSION

In our marketing-oriented economy, it is becoming increasingly important for the marketer to understand consumer motivation. With an abundance of goods from which to select, the consumer seldom has to settle for products which are second rate. As social creatures, consumers are strongly influenced in their buying decisions by the social environments of which they are parts. The marketer can ill afford to ignore the social influences on consumer motivation, and the executive who capitalizes on this knowledge should reap benefits in terms of sales volume, profits, and growth in both sales and profits.

### QUESTIONS AND PROBLEMS

1. Are psychological and sociological motives within the individual likely to be in conflict at times? If so, how would such conflicts affect the marketer?
2. When an individual is a member of several peer groups, are his consuming activities likely to be affected equally by all groups? Please explain.
3. Does membership in a peer group result in conformity in the actions of its members? Does this have implications for marketing?
4. Would you conclude from what sociologists know about masses that there is no such thing as a mass market? Why or why not?
5. Try to enumerate five products pretty clearly related to the lower class, the middle class, and the upper class, respectively.
6. How might Warner's six-class structure be more useful to a marketer than the ordinary three-class structure?

7. Do you think that the decline in the importance of the automobile as a status symbol in the United States indicates a decreasing importance attached to status symbols by American society? Discuss.
8. Would you agree that social mobility is an important prop to consumption in the United States? Why or why not?
9. Minority racial and ethnic groups in the United States generally perceive promotion and products in a different light and, thus, require different marketing treatment. Comment on this statement.
10. In American society, the housewife has become the primary purchasing agent for the family. Is it safe to assume that, with this greater responsibility for buying has gone an increased authority to make buying decisions?
11. Individuals with high opportunity costs for leisure offer the best potential market for goods. Please explain.
12. The rapidly increasing importance of fashion in men's clothing presents an excellent example of how competent marketers can foist on the public something it does not want. Comment.
13. Comment on the statement that fashion is the pursuit of novelty for its own sake.
14. Why do you suppose some products have status connotations and others do not? Which group might be easier to sell?

# LEGAL RESTRAINTS

## 10

As we have emphasized, no marketing decision-maker ever enjoys complete freedom; many uncontrollable factors—economic, psychological, and sociological—limit his freedom in choosing among different courses of action. In addition to these limits there are the legal restraints. Frequently, the decision-maker finds that certain alternatives have to be discarded because they are either plainly illegal, or at least of doubtful legality. In this chapter, we will examine the principal legal restraints on marketing decision-making.

Our focus will be, primarily, on the ways the law limits the marketing decision-maker. Some laws, however, legal-

ize actions which would not otherwise be possible. For example, patent law protects a manufacturer for a period of time from having his product duplicated by competitors. Similarly, a manufacturer may register his trade-mark with the United States Patent Office and receive a degree of legal protection against others using or "adapting" it. In these and a few other instances, the law actually widens the scope within which marketing decisions can be made. However, these are the exceptional cases, for the law generally narrows this range.

### WHY LEGAL RESTRAINTS ON MARKETING?

Most of the legal restraints placed on marketing have come about because of the desire of law-making bodies to preserve competition. Business competition is one of the cornerstones of any free enterprise economy. It serves as a sort of natural protector of the public interest by forcing individual enterprises to produce and market those goods and services most in demand and, if competition functioned perfectly as an economic regulator, at prices just sufficient to cover costs. Although such competition, called "pure competition" by the economist, has probably never existed, either in the United States or anywhere else, the benefits of competition are, as supposed in economic theory, sufficiently important that a high degree of competition is considered desirable. Keeping the level of competition as high as possible has long been considered a necessary and proper function of government. Generally speaking, the government has not intervened except where business activities tended to cause competition to break down or disappear. This philosophy was summed up by a former chairman of the Federal Trade Commission:

... The instrument devised to snip the tentacles of monopoly was the anti-trust laws. Instead of transferring economic power from one monolith to another, a method was invented to promote dispersal of power among private entrepreneurs. The major premise of antitrust is an unshakable belief in the efficacy of a competitive, free enterprise economy. The ideal to be realized is unlimited opportunity for entry into the market place, unlimited opportunity for self-development, and the resolution of economic issues by the unchecked exercise of free market forces.<sup>1</sup>

### *The Law and Marketing Decisions*

The relationship of the law to the making of marketing decisions is often very vague. Law is actually a complex of limitations coming from a number of different sources. Not only are there both federal and state law-making bodies, but courts at both levels which, in rendering judicial

<sup>1</sup> E. W. Kintner, "How Much Control Can Business Endure?" *Journal of Marketing*, Vol. 25, No. 5 (July 1961), p. 3.

interpretations, set precedents for decisions in further cases. Courts reach their decisions not only on the basis of statutory law but also according to the common law, which itself evolves over time as the cumulative result of court decisions on matters for which statutory law either provides no guidance or leaves room for differences in interpretation. Furthermore, some governmental agencies (for example, the Federal Trade Commission or the Food and Drug Administration) are charged with administering various pieces of legislation, while others (such as the Antitrust Division of the United States Department of Justice or the Federal Trade Commission) carry out the enforcement provisions of these pieces of legislation. Small wonder, then, that lawyers are reluctant or unable to state what "the law" is in every possible situation. One legal expert comments on this matter in these words: <sup>2</sup>

We do not have, as some may think, a complete set of rules, exact in every detail, ready to be applied to any situation that may arise. Legal reasoning involves the fitting of a particular situation into the fabric of legal history. To do this requires consideration of several questions. Has there been a similar situation in the past? If so, how was it treated? Has there been any change in treatment through legislation? Despite apparent similarity, are there any significant distinctions between the present situation and those of the past? If there have been no similar situations in the past, have there been analogous situations? If no analogous situations have arisen, is there any legislation that may be applicable? What is the intent, meaning, and scope of such legislation? Has there been any extra-judicial writing on the subject? Are there any general or basic principles or concepts that may be applied? What effect will a decision in this matter have upon the future? It is difficult to say that any one item is of greater importance than any other. Whatever may shed light on the matter to be decided is considered before a final determination is reached.

So, in most instances, the law provides no clear-cut guides for marketing decision-making. It is convenient to think of the body of law as constituting the "rules of the game," but the rules are subject to differences in judicial and administrative interpretation and are almost constantly changing. Furthermore, the vigor with which different aspects of the law are enforced varies both with the budget of the enforcement agency and with the strategy that agency chooses to pursue. It is not surprising, then, that the legal implications of specific marketing decisions are often difficult to predict.

One government agency, however, the Federal Trade Commission, has been outstanding in its efforts to provide marketing decision-makers with some clarification of the laws it administers and enforces. Historically, the FTC has sponsored trade practice conferences to serve this

<sup>2</sup> W. Zelemyer, *Legal Reasoning* (Englewood Cliffs, N.J.: Prentice-Hall, 1960), pp. 5-6.

purpose. The outcome of such a conference, to which all known members of a particular industry are invited (manufacturers, wholesalers, retailers, and other interested parties), is a set of trade practice rules designed to eliminate and prevent, on a voluntary and industry-wide basis, trade practices and methods of competition and business behavior which constitute violations of laws administered by the commission. By mid-1960, trade practice rules had been formulated by 164 different industries. The other chief means used by the FTC to provide clarification of the laws it administers and enforces has been the publication and widespread circulation of various guides illustrating what is legal and illegal. Reference is made to several of these guides later on in the chapter.

The following discussion is organized around the five main decision areas in marketing which are most affected by legal restraints: competitive action, product, price, distribution channels, and promotion. Our intent is to provide marketing decision-makers with some appreciation of the legal boundaries, however vague and even ill-defined they may sometimes be, within which certain decisions must be made. In appraising the legal implications of any specific marketing decision, management should consult competent legal counsel.

### COMPETITIVE ACTION

Many marketing decisions have, purposely or not, considerable impact on competitors. In fact, nearly every marketing decision has at least some effect on competition. This is certainly inherent in most decisions on those marketing areas discussed in succeeding sections of this chapter—decisions on products, prices, distribution channels, and promotion. Our concern at this point, however, is with the sort of decisions which may *directly* affect competition and possibly expose the company to prosecution under the antitrust statutes.

#### *Decisions Involving Expansion*

Decisions involving expansion, particularly if the company is already of substantial size, should be made only after taking into account the possibilities of antitrust prosecution; the legal danger is that the company *may* be charged with unlawfully monopolizing or attempting to monopolize a market. There are only two avenues of corporate growth—one through gradual, natural expansion, the other through merger with or acquisition of other firms. Either may lead eventually to antitrust prosecution but, historically at least, lawmakers and enforcement agencies have shown greater interest in the merger or acquisition route than in the natural expansion route.

Legal restraints on growth have gradually become more restrictive.

The first piece of federal antitrust legislation, the Sherman Antitrust Act of 1890,<sup>3</sup> in its Section 2, declared monopolization or attempts to monopolize illegal. Various difficulties in enforcing the Sherman Act, together with certain judicial setbacks suffered by the government, resulted in the enactment of the Clayton Antitrust Act in 1914.<sup>4</sup> Section 7 of the Clayton Act prohibited a corporation from acquiring stock in a competing corporation in the same industry or line of commerce, and prohibited a holding company from acquiring the stock of two or more competing corporations where such acquisition would substantially lessen competition, or restrain commerce, or tend to create a monopoly. At this point, the law still did not prevent corporate merger through the acquisition by one corporation of the assets of another, or of several competitors. In 1950, Section 7 of the Clayton Act was amended by the Celler-Kefauver Antimerger Act,<sup>5</sup> which aimed to block this method of corporate growth through the acquisition of assets.

Not every corporate merger or consolidation is illegal—only those which *may* have the defined adverse effect on competition. In short, any acquisition or merger is illegal if its effect is “substantially to lessen competition, or to tend to create a monopoly.” Such acquisitions or mergers may be horizontal (with competitors), vertical (with suppliers or customers), or conglomerate (with concerns producing entirely different products or marketing them in quite different markets). Lessening of competition means, in general, a decrease in competition or a foreclosure of competitors from the market. In other words, when competition is lessened, monopoly power exists.

Monopoly power has been generally defined by the courts to consist of the power to control prices or the power to exclude competition—with strong emphasis on the word “power.” This is what the government attempts to prove in prosecuting alleged violations of Section 7 of the Clayton Act as amended by the Celler-Kefauver Antimerger Act. It does *not* have to prove intent, i.e., that the corporation acquiring stock or assets intended to lessen competition or to create a monopoly.<sup>6</sup> All that the government has to show is that there is a *reasonable probability* that the acquisition will have the prohibited lessening effect on competition.

The issues to be determined in an action challenging the legitimacy of an acquisition include the line or lines of commerce (i.e., the type of business or the product involved) and the section or sections of the country in which the effects may be felt or the “area of effective com-

<sup>3</sup> 26 Stat. 209, Chap. 647.

<sup>4</sup> 38 Stat. 730, Chap. 323.

<sup>5</sup> 64 Stat. 1125.

<sup>6</sup> *U.S. v. E. I. du Pont de Nemours and Co., et al.* (U.S. Sup. Ct. 1957) 353 U.S. 586.



petition."<sup>7</sup> Thus, the outcome often turns on the particular definition of "share of the market" which the court accepts. The share-of-the-market concept obviously combines both the question of the type of business or the product involved, and that of the geographic market areas in which competitors vie for sales. In the famed *Cellophane* case, the issue boiled down to whether du Pont was competing in the cellophane market, where it had approximately 75 per cent of the market, or in the "flexible wrapping materials" market (which includes not only cellophane but even such items as wax paper and gift wraps), where the company had less than 18 per cent of the total business.<sup>8</sup> In a case over the proposed merger of two steel companies, Bethlehem Steel Corporation and Youngstown Sheet and Tube Company,<sup>9</sup> it was established that any geographic market area where two companies "have in the past made sales" or "where potentially they could make sales and where buyers could reasonably turn to them as alternative substantial sources of supply" was a relevant market area for use in judging the potential effects on competition.

The merger or acquisition route to expansion is fraught with legal complications, but companies which choose to take the natural growth route also have their problems. Once a company has achieved substantial size, and as it gains an increasing share of the market, management begins to fear the possibility of adverse government action.<sup>10</sup> There is little question but that in such a company, out of fear of government action, there is often a tendency to hobble the competitive skills at management's command. Mr. George Romney, ex-president of American Motors Corporation, proposed a possible solution to this dilemma:<sup>11</sup>

... the antitrust laws should provide that when any one firm in a basic industry, such as the automobile business, exceeds a specific percentage of total industry sales over a specified period of time, it shall be required by law to propose to an administrative agency a plan of divestiture that will bring its percentage of sales below the specified level. Where a firm is engaged in more than one basic industry, the maximum percentage of total industry sales should be fixed by law at a point lower than the percentage to be fixed for companies operating in only a single basic industry. Where

<sup>7</sup> *U.S. v. Bethlehem Steel Corp., et al.* (D.C. N.Y. 1958) 157 F. Supp. 877.

<sup>8</sup> Ultimately, the court decided that the relevant market was that for all flexible wrapping materials and du Pont was acquitted. See: *U.S. v. E. I. du Pont de Nemours and Co.*, 76 S.Ct. 994 (June 1956).

<sup>9</sup> *Op. cit.*

<sup>10</sup> G. Romney, "Toward Economic Freedom—A Plan for Coping with Bigness," *Business Horizons*, Vol. 2, No. 2 (Summer 1959), p. 26.

<sup>11</sup> Testimony in "Administered Prices," hearings before the Subcommittee on Anti-trust and Monopoly, Committee on the Judiciary, U.S. Senate, 85th Congress, 2nd Session, 1958, pt. 6, pp. 2887-2889.

a company is engaged in more than one basic industry, its competitive position is strengthened and it is able to dominate a single market with a lower percentage. This results from its ability to concentrate its resources on a single industry or product at any time and to expand its market position by relying on earnings from its other activities.

This proposed amendment of the antitrust laws would have a number of advantages:

1. It would promote and preserve adequate competition.
2. The companies affected, not the Government, would have the opportunity to originate the method of compliance.
3. Achievement of the sales percentage requiring a split off or "birth" would become evidence of economic success.
4. Competitive effort and growth would be encouraged, not restrained.
5. Instead of making mere size itself an offense, the test under the law would be based on the size of a company in relation to that of its competitors. In big industries there would be big companies.
6. An adequate number of companies in each basic industry would be assured.

#### *Decisions Requiring Cooperative Relations with Competitors*

Most marketing decisions involving any sort of cooperative relationship with competitors should be entered into only with an acute consciousness of the antitrust laws. Particularly vulnerable to antitrust prosecution are price agreements with competitors, for under the law they are illegal *per se*. This means, in effect, that the courts will condemn them without considering any mitigating circumstances which may have caused them. A variety of pricing practices involving combinations of or conspiracies among competitors are considered illegal. It is not only illegal for competitors to fix prices among themselves, but also for them to agree upon uniform terms of sale. It is illegal for competing firms to use the same basing-point system in making price quotations, i.e., to compute delivered-price quotations all from the same shipping point or points; the effect of a basing-point system used by two or more competitors is that all sellers' prices are uniform to any one buyer, regardless of his or their geographical locations. Collusion among bidders is another pricing practice strictly prohibited and fairly frequently the subject of court action. Any management is "skating on thin legal ice" when it permits itself to be drawn into *any* sort of pricing arrangement with competitors—even the exchange of price lists among competing firms has been held to constitute evidence of illegal collusion.

Many other cooperative relationships with competitors are just as likely to result in antitrust prosecution. For instance, in the women's dress industry, a combination of designers, manufacturers, converters, and dyers used restrictive sales agreements with retailers to prevent other

manufacturers from copying designs for sale at lower prices. Although the intent of the combination was to prevent "style piracy," the court ruled that the agreement was illegal since the means used to gain this end went against federal law.<sup>12</sup> In another case, manufacturers of street lighting equipment were enjoined by a consent decree (an agreement entered into as an alternative to prosecuting) from conspiring to divide among themselves manufacturing or sales territories, customers, or distribution channels, among other practices.<sup>13</sup> In still another case, manufacturers of soda ash were enjoined in a consent decree from acquiring or threatening to acquire excess productive facilities not intended to be used by them, but effective as a threat against competitors and discouragement of prospective entrants into the field.<sup>14</sup> These illustrations should emphasize the necessity for considering the antitrust implications of any decision which, to be carried out, would require the cooperation of competitors.

#### *Decisions on Competitive Tactics*

The law has limited the tactics a company can use in fighting a competitor. It has been held illegal, for example, for a company to misrepresent or disparage a competitor's products, its methods of doing business, or its financial standing and reliability. It is also illegal to cut off a competitor's source of supply, whether by individual effort or in collusion with others. In one court case, for example, the use of special contracts as a device to sell oranges to favored processors at a substantially lower price, where the seller controlled 70 per cent of the available oranges and had the power to set prices, was held unlawful since the effect was to exclude a complaining processor from competition.<sup>15</sup>

#### **DECISIONS ON PRODUCTS**

There are several main reasons why legal restraints have been imposed on the making of certain product decisions. Some restraints came about as side effects of the legislative effort to preserve and maintain a high degree of competition in the economy as a whole. Other restraints trace to the legal protection afforded individual concerns against having their products duplicated by others. And still other restraints exist because of the desire of lawmakers and governmental agencies to protect the

<sup>12</sup> *Fashion Originators' Guild of America, Inc., et al. v. F.T.C.*, CCH, *Trade Cases* (1940-1943), Par. 56,101.

<sup>13</sup> *U.S. v. General Electric Co., et al.* (D.C. Ohio 1952), CCH, *Trade Cases* (1952), Par. 67,301.

<sup>14</sup> *U.S. v. Solvay Process Co., et al.* (D.C. Kansas 1944), CCH, *Trade Cases* (1944-1945), Par. 57,229.

<sup>15</sup> *Sunkist Growers, Inc. v. Winckler & Smith Citrus Products Co.*, CCH, *Trade Cases* (1960), Par. 69,823.

interests of consumers. In operational terms, these restraints affect decision-making with respect to adding new products, product design, product quality, and information included on the product label.

#### *New Product Addition*

Decisions on new products may be equivalent to the decisions on expansion discussed earlier. If a new-product decision is tied to a decision on a merger with or an acquisition of another firm, the provisions of the Celler-Kefauver Antimerger Act will, of course, apply. Such a merger or consolidation is illegal, if it *may* tend to "substantially lessen competition or tend to create a monopoly." Similarly, if a new-product decision requires the purchase of certain assets from another firm, i.e., without actually merging or consolidating with that firm, there may be antitrust prosecution on the grounds that this *may* have an adverse effect on competition. Existence of these restraints strongly suggests that, from a legal standpoint, the safest way of securing new products is through their origination in the firm's own research and development program.

#### *Product Design*

Decisions on product design are subject to restraints imposed by patent law. The holder of a design patent is protected against others using his design during the term the patent is in force, which may be for 3½, 7, or 14 years. Patents initially granted for terms of 3½ or 7 years are renewable, but may not be in effect for more than 14 years in all. During the time a design patent is in force, its holder enjoys what is, in essence, a monopoly over its use. If he wishes, he may license others to use the patent receiving royalty payments in return, but, except in rare instances, he is under no legal compulsion to do so. Thus, the law keeps a firm from designing a product that is "similar" to one made and patented by a competitor. (A product is considered "similar" if consumers consider its design or outward appearance to be the same as that of an established product.) Patent law is extremely complicated, especially in the matter of what constitutes an "illegally similar" product design. Therefore, in deciding on product design, management does well not only in guarding against copying competitive designs, but in retaining the help of competent patent attorneys.

#### *Product Quality*

In some product areas, the law limits the discretion enjoyed by management in making decisions on product quality. The Food, Drug, and Cosmetic Act,<sup>16</sup> for instance, enacted by Congress in 1938, authorizes the

<sup>16</sup> 52 Stat. 1046, Chap. 3.

Food and Drug Administration to establish minimum quality standards for food products. The act also gives this agency the power to fix standard grades for specific kinds of food products and, as a result, many official grade definitions have been published including ones for most canned fruits and vegetables. Packers are not forced to affix the official grade designations to their products, but they are legally required to keep product quality as high as the "identity standard" (the standard set up for the relevant official grade). This act also prohibits the adulteration and sale of any food, drug, therapeutic device, or cosmetic that may endanger public health; the law defines what constitutes adulteration within each of these product classes. There are, in addition, numerous state and local laws relating to the quality of individual products such as milk, cheese, and cream.

### *Product Labeling*

Special laws, applicable to some industries, regulate the nature and content of the information which must be included on the product label. For products coming within the regulatory authority of the FDA, the label must identify the manufacturer or distributor, describe the contents of the package, reveal the quantity in the package, and state a warning if the product is dangerous to use or habit-forming. If a product is a flammable fabric, the Flammable Fabric Act<sup>17</sup> requires that there be a warning to that effect.

The Textile Fiber Products Identification Act of 1958,<sup>18</sup> enforced by the Federal Trade Commission, specifies that products containing natural or artificial textile fibers intended for sale to ultimate consumers must be tagged or labeled to show: (1) the generic name or names (i.e., names actually descriptive of the fibers) of the fibers contained (for any fiber which constitutes five per cent or more of the total fiber weight of the product); (2) the percentage of each fiber present, and (3) the country of origin, if the fiber is imported. Furthermore, the name of the manufacturer or other concern marketing the product must appear on the label. Similar labeling requirements for wool and fur products are contained in the Wool Products Labeling Act (1939)<sup>19</sup> and the Fur Products Labeling Act (1959).<sup>20</sup> Sellers who fail to comply with these labeling requirements are charged with misbranding.

In all industries not covered by the special laws noted above, the FTC maintains a constant watch for instances of misbranding. Mis-

<sup>17</sup> 67 Stat. 111, Chap. 164, Secs. 1-13.

<sup>18</sup> 72 Stat. 1717.

<sup>19</sup> 54 Stat. 1128, Chap. 871.

<sup>20</sup> 65 Stat. 175, Chap. 298.

branding generally means some form of misrepresentation on a label as to the composition, properties, or origin of the product. So, to comply with the law, a label must be accurate and complete in all essential details.

State and local laws also contain provisions regarding the quality and labeling of specific products. For example, the Florida Citrus Commission enforces certain quality standards for such citrus products as chilled orange juice sold in paper cartons. During certain seasons of the year, the oranges available do not produce juice with enough solids to meet the commission's standard. The standard can be met, however, by adding sugar to the juice; but, when this is done, the commission requires the packer to label the product "substandard." The courts have held that this regulation is necessary to protect the consuming public against deception.<sup>21</sup>

### PRICE DECISIONS

Among the most basic marketing decisions are those on pricing, and no class of decisions is more hedged in by legal restraints. Federal anti-trust legislation has implications for pricing for, as mentioned previously, the "power to control prices" is one of the tests applied by the courts in determining the existence of monopoly power. By the terms of the Clayton Act, the practice of discriminating in price among buyers was declared illegal if the effect was "substantially to lessen competition or tend to create a monopoly in any line of commerce." Passage in 1936 of the Robinson-Patman Act,<sup>22</sup> amending Section 2 of the Clayton Act, added further conditions under which companies could be charged with price discrimination, and outlawed certain other practices involving negotiations between sellers and buyers. For most sellers, the Robinson-Patman Act contains by far the largest group of restraints on pricing decisions. Among the other laws affecting pricing decisions is legislation at the state level permitting resale price maintenance and forbidding sales below cost. In the following sections we will consider these restraints on the making of price decisions.

#### *Price Discrimination*

The Clayton Act, as amended by the Robinson-Patman Act, prohibits any direct or indirect price discrimination by a seller among different purchasers of commodities of like grade and quality, where the effect is to injure competition. The law prohibits price discrimination, but it does

<sup>21</sup> *Florida Citrus Commission v. Golden Gift, Inc.*, 91 So. 2nd 657 (Fla. Sup. Ct., Oct. 11, 1956).

<sup>22</sup> 49 Stat. 1526, Chap. 592.

permit certain differentials in price. A seller may vary his prices among buyers in line with differences in costs incurred in serving them, but the differential legally cannot exceed differences in the cost of manufacture, sale, or delivery resulting from differing methods or quantities in which commodities are sold or delivered; moreover, the seller must be prepared to justify such differences if he is charged with price discrimination. Proving that such differences are justified is extraordinarily difficult. Respondents in price discrimination cases have sometimes spent large sums on cost studies only to find that the findings "do not stand up in court." As one authority puts it, "it is one thing to agree on costs among businessmen where litigation is not involved, and it is quite another to make the kind of showing of costs which will stand up under the testing which it receives in a courtroom."<sup>23</sup>

Price discriminations resulting from the attempts of sellers to meet competitors' prices apparently were legalized under provisions of Section 2(a) of the Robinson-Patman Act. Charged with price discrimination, many companies have based their defenses on the contention that they were acting in "good faith" in meeting competitors' price reductions. Unfortunately, however, different courts have rendered what appear to be inconsistent decisions and have not spelled out clearly the conditions under which the "good faith" defense would be accepted or rejected. Consequently, it is impossible to draw definite conclusions about the use of this defense, but the facts seem to indicate that this portion of the law is of little help as a guide in making pricing decisions.<sup>24</sup>

Provisions of the Robinson-Patman Act also legalize differences in price which result from fluctuating market prices, the threatened obsolescence of a perishable product, or other abnormal marketing conditions.

**NON-CUMULATIVE QUANTITY DISCOUNTS.** A non-cumulative quantity discount is a price reduction allowed a buyer for placing a single order for a single shipment of a given product quantity. Under the law, a seller must start with a basically uniform price to all comparable buyers, e.g., to all wholesalers. He can quote lower prices for larger orders, but he must make the same offer available to all comparable buyers. Furthermore, he must be prepared to prove that a lower price given on a particular size of order was justified by savings in costs of manufacturing, selling, or delivering. The non-cumulative quantity discount,

<sup>23</sup> H. F. Taggart, "The Role of Cost in Public Policy Toward Business," in L. H. Stockman (Ed.), *Advancing Marketing Efficiency* (Chicago: American Marketing Association, 1959), p. 333.

<sup>24</sup> L. X. Tarpey, "What About the Good-Faith Defense?" *Journal of Marketing*, Vol. 25, No. 1 (July 1960), p. 65.

based as it is on the size of a single order and shipment, is relatively the easiest discount to justify under the Robinson-Patman Act.

**CUMULATIVE QUANTITY DISCOUNTS.** A cumulative quantity discount is a price reduction allowed to a buyer who purchases a given quantity of a product over some specified period. It is based, in other words, on the cumulative purchases of a customer made within some period of time, usually a year. The Robinson-Patman Act does not specifically outlaw such discounts, but they are extremely difficult to justify in terms of cost savings. Suppose, for example, that customer *A* buys \$200,000 worth of goods in a year as a result of 50 calls by salesmen and the placing and filling of 50 separate orders, and that customer *B* places a single order for \$200,000 worth of merchandise. It is easy to see that the costs of selling and shipping to *A* would be greater than they would to *B*, and it would be virtually impossible to justify a cumulative quantity discount to *A* on the basis of cost savings. This illustrates why pricing schemes which include cumulative quantity discounts are so vulnerable to charges of price discrimination.

**FUNCTIONAL DISCOUNTS.** A manufacturer often sells his product to customers engaged in different phases of distribution. For instance, a manufacturer of household paper products may distribute some of his production through wholesalers and the rest directly to retail outlets. In these instances, the price to wholesalers must ordinarily be lower than to retailers. The wholesaler not only has expenses of doing business but must price the product to retailers at a low enough figure for them to compete with those retailers who buy directly from the manufacturer. In this example, the discount given to wholesalers but not to retailers is known as a functional discount, i.e., a discount based on difference in function.

The Robinson-Patman Act is silent on the question of whether such discounts are legal or illegal. In determining the legality of a particular functional discount, it is necessary to ascertain its effect on competition. If it may injure competition, it is illegal. With regard to the illustration in the preceding paragraph, if the wholesaler is engaged strictly in the wholesaling of the manufacturer's products, and the retailer strictly in retailing them, and if all wholesalers are extended identical functional discounts and all retailers sold directly pay the same price, then the price differential should not have an adverse effect on competition and the functional discount would be legal. But where the wholesaler *competes* with the retailer in selling directly to the consumer—even where he also makes sales to retailers—or where a customer who might be



classified as a retailer actually performs what is in some degree a whole-sale function—such as reselling to other retailers—then that difference in price will have a tendency and capacity to injure competition and the functional discount is likely to be held illegal.<sup>25</sup>

**“DUMMY” BROKERAGE PAYMENTS.** Before the Robinson-Patman Act was passed, large buyers, especially corporate chains, often obtained the benefits of price discrimination through the subterfuge of maintaining a purchasing subsidiary which operated ostensibly as a broker for prospective sources of supply. Such subsidiaries charged sellers the normal brokerage fees and passed them back to parent companies. “Dummy” brokerage payments of this kind were outlawed by Section 2(c) of the Robinson-Patman Act. In enforcing this provision, the Federal Trade Commission has considered brokerage relationships artificial and illegal when indirect control over the broker by the buyer could be proven. It is illegal either to receive or to pay dummy brokerage fees. Furthermore, it is illegal for a seller to grant and a buyer to accept an extra discount in place of a brokerage fee.

**LIABILITY OF BUYERS AT DISCRIMINATORY PRICES.** Section 2(f) of the Robinson-Patman Act prohibits buyers from inducing or knowingly receiving the benefits of price discrimination. One recent case involved several automotive parts wholesalers who formed a buying association in order to obtain quantity discounts which they could not have obtained separately. Individual members of the association submitted direct and unconsolidated orders to suppliers who, in turn, made direct shipments to members. Suppliers realized no savings in shipping and order-processing costs and, consequently, there was no cost justification for the lower prices; the arrangement was judged a violation of Section 2(f).<sup>26</sup>

#### *Resale Price Maintenance*

Resale price maintenance or “fair trade” refers to the legal process whereby a manufacturer sets the prices at which middlemen may resell his brand. Until the 1937 passage of the Miller-Tydings Act,<sup>27</sup> amending Section 1 of the Sherman Act, vertical price agreements (e.g., between a manufacturer and any middleman) were illegal in interstate commerce. The Miller-Tydings Act, in effect, made it lawful for a manu-

<sup>25</sup> A. G. Seidman, “Some Aspects of the Law Concerning Pricing,” in *Competitive Pricing*, A.M.A. Management Report No. 17 (New York: American Management Association, Inc., 1958), p. 63.

<sup>26</sup> *American Motor Specialties Co., Inc. v. F.T.C.*, CCH, *Trade Cases* (1960), Par.-69, 712.

<sup>27</sup> 50 Stat. 693, Chap. 690, Title VIII.

facturer to enter into a vertical price agreement with resellers situated in states which had laws permitting resale price maintenance. By 1961, at one time or another, 46 states had enacted such laws—all but Alaska, Missouri, Texas and Vermont, and the District of Columbia. Of these acts, two (those of Montana and Utah) had been declared unconstitutional by upper courts, and one (that of Ohio) had been so declared by a lower court.

The most controversial feature of the state fair trade acts has been the nonsigners' clause. This clause permits a brand owner to sign a resale price maintenance contract with any dealer or distributor and, upon giving notice to all dealers or distributors involved in the particular state, the contract becomes binding on all parties selling the brand. By 1961, the nonsigners' clause had been declared unconstitutional in 19 states, constitutional in 16, and was under attack in several others.

The Miller-Tydings Act did not legalize any price fixing except that conforming to state laws allowing resale price maintenance. It was silent with respect to the legality of the nonsigners' provision in state laws. In the famous *Schwegmann Brothers* decision of 1951, the United States Supreme Court held that price fixing by compulsion against non-contracting dealers, although permitted by state acts, was a violation of federal antitrust laws.<sup>28</sup> The next year, in 1952, Congress passed the McGuire Act,<sup>29</sup> modifying the Miller-Tydings amendment to Section 1 of the Sherman Act. The McGuire Act nullified the effect of the *Schwegmann* decision by specifically exempting from federal antitrust prosecution those fair traders who desired to enforce fair trade prices among nonsigners in states where such action was permitted. In addition, the McGuire Act (1) legalized contracts establishing *stipulated* prices as well as those prescribing only minimum prices, and (2) made it legal for a brand owner, where allowed by state law, to require a wholesale buyer to enter into a resale price agreement with his customers for purposes of making the established resale price effective.

The so-called "fair trade" states vary as to whether minimum or absolute resale prices may be agreed upon and as to the conditions under which resellers are permitted to depart from the fair trade price. Whereas most states permit the establishment only of minimum resale prices, 15 states also allow the setting of absolute resale prices. In most states, reductions from the established price are legal when the product is altered (e.g., a man's suit returned by a customer), second-hand, damaged, or deteriorated. In nearly all states, price reductions on fair traded items are permitted when made by an officer acting under court order. In 15 states (only coincidentally the same number as those allowing the setting

<sup>28</sup> *Schwegmann Bros. et al. v. Calvert Distillers Corp.*, 341 U.S. 384.

<sup>29</sup> 66 Stat. 631, Chap. 745.

of absolute resale prices) reductions from the fair trade prices are allowed when the trade-mark, brand, or name is obliterated or removed from the product.

The rise of trading stamps as a retail promotional device has had an impact on fair trade practice. In more than half of the states, retailers may not give trading stamps with the sale of fair traded items; but there are many exceptions to this including such populous states as California, Illinois, Michigan, New Jersey, and New York. Courts in some states have held that trading stamps are a form of cash discount, i.e., a reduction given to customers for prompt payment of cash. In these states, then, the fair trade laws are considered not violated when trading stamps are given along with purchases of fair traded goods.<sup>30</sup> This doctrine, known as the "cash discount" theory of trading stamps, is highly controversial and will undoubtedly continue to be challenged in the courts.

#### *Restrictions on Minimum Prices*

Minimum prices have been the subject of legislation in many states. By 1961, Unfair Sales Acts or Unfair Trade Practices Acts, prohibiting sales below cost-plus-a-certain-percentage markup, have been passed in 31 states. These are laws of general application, applying to all goods sold by wholesalers and retailers, and there are no requirements, as in the case of the fair trade laws, that the goods be branded or formal vertical price-fixing agreements be signed. Some of these laws, e.g., those of Connecticut and Wisconsin, specify minimum percentage markups over cost as the lowest price at which any item may be resold. The usual figures are 2 per cent over the wholesaler's cost and 6 per cent over the retailer's cost, with cost being defined as the invoice cost. Arizona has no minimum percentage markup for wholesalers but decrees a minimum 12 per cent markup over cost for retailers. In a few states there are no specific markup requirements and net purchase cost is considered the minimum resale price. There is a provision in most state laws stating that the act applies where there has been "the purpose... or the effect of injuring a competitor or destroying competition." It should also be noted that the FTC considers it to be an unfair competitive practice for a seller to sell below cost in order to drive out competitors. Most Unfair Trade Practices Acts permit sales at prices below cost for certain types of transactions including sales of seasonal or perishable goods, clearance sales, and sales to meet the legal prices of a competitor.

More than a score of states have laws prohibiting sales below cost

<sup>30</sup> *Corning Glass Works v. Maz Dichter Co., Inc., and Man-Bur Sales, Inc.*, CCH, *Trade Cases* (1960), Par. 69,743.

for specific classes of products. Alabama, Arkansas, Indiana, Maryland, Massachusetts, New Jersey, Ohio, and Washington forbid either wholesalers or retailers to sell cigarettes below cost. Arkansas prohibits the wholesale or retail sale of liquor below cost. Louisiana outlaws below-cost retail sales of drug and cosmetic products. Massachusetts prohibits below-cost wholesale and retail sales of motor fuel. Utah forbids sales by manufacturers, wholesalers, and retailers of agricultural products at prices less than cost-plus-6%.

Evidently, in some jurisdictions, it is possible to circumvent the sales-below-cost laws through the use of trading stamps. In Oklahoma, for instance, a chain grocery retailer was prevented from making price reductions in order to meet trading stamp competition. The Oklahoma Supreme Court ruled that trading stamps were a cash discount, and therefore could not be considered a price cut which could be met by a competitor. The United States Supreme Court later upheld this decision.<sup>31</sup> In Minnesota, however, several retailers were charged with violating the state Unfair Trade Practices Act when they gave "bonus" stamps, or trading stamps in excess of the number regularly given, and the court granted temporary injunctions against the practice.<sup>32</sup>

#### DISTRIBUTION CHANNEL DECISIONS

With comparatively few exceptions (e.g., the public utilities industry), the law does not interfere with the manufacturer's freedom to determine his own distribution channels, or to "pick and choose" from among the available middlemen those whom he desires as members of his channel team. But once buying-selling relationships have been established with middlemen customers, the law is concerned in a number of instances with the nature of these relationships.

Many of the earlier-discussed legal restraints on marketing decisions also apply to decisions bearing on the manufacturer's relations with the middlemen in his distribution channel. For instance, provisions of the Celler-Kefauver Act determine the legality of a vertical merger of a manufacturer with one of his customers. The legality of the merger would depend on whether there was a reasonable probability that competition might be adversely affected—i.e., either with other manufacturers or with businesses that formerly competed with the customer. Similarly, inasmuch as price decisions strongly influence the relationships of buyers and sellers, nearly all the discussion of such topics as price discrimina-

<sup>31</sup> *Safeway Stores, Inc., v. Oklahoma Retail Grocers Association, Inc.*, 79 S. Ct. 1198 (June 1959).

<sup>32</sup> M. C. Howard in K. J. Curran (Ed.), "Legal Developments in Marketing," *Journal of Marketing*, Vol. 25, No. 4 (April 1961), p. 80.

tion and resale price maintenance would apply with equal force here. We leave it to the reader to think through such legal restraints as those imposed by the Robinson-Patman Act, the state Fair Trade Laws, and the McGuire Act, and to determine for himself their implications for decisions involving relationships with members of distribution channels.

There are other legal restraints bearing on the manufacturer's relationships with middlemen which have not yet been discussed. These are examined in the following paragraphs.

### *Exclusive Dealing*

The term "exclusive dealing" refers to an arrangement where a manufacturer agrees to permit a dealer to handle his product only if the dealer consents to buy all his requirements for this type of product from the manufacturer and none whatever from competing suppliers. Generally speaking, any contract with a buyer requiring him to buy all his needs from one supplier is illegal.<sup>33</sup> But, as ever, it is a necessary condition for illegality that competition be impaired or threatened. This condition is practically always present and relatively easy to prove, for the effect of exclusive dealing is necessarily the foreclosing of competitors from selling to dealers who have signed an exclusive dealing contract with a supplier. The Federal Trade Commission prosecutes exclusive dealing arrangements under Section 3 of the Clayton Act, which prohibits exclusive dealing when the effect is "to substantially lessen competition or tend to create a monopoly in any line of commerce." While a dealer may entirely on his own volition decide to buy from only one supplier, existence of a formal contract to that effect is likely to be construed as evidence that the supplier applied unlawful pressure in forcing the decision. It is also illegal for a supplier to refuse to sell to a dealer who stocks competitive products, if that dealer has previously handled the supplier's brand; it is up to the dealer involved, in such cases, to decide whether or not to continue dealing with the competition.

### *Tying Contracts*

Section 3 of the Clayton Act also prohibits the tying contract, a device closely related to exclusive dealing. A tying contract involves the sale or lease of products on condition that the purchaser or lessee buy or use certain other goods that the seller or lessor offers to supply. For a manufacturer to make effective use of either exclusive dealing or tying contracts, he must possess powerful leverage with respect to at least some

<sup>33</sup> *U.S. v. American Optical Co., et al.* (DC Ill. 1951), CCH, *Trade Cases* (1950-51), Par. 62,869.

of the goods offered for sale, as happens, for instance, when a manufacturer markets a brand so strongly preferred by consumers that dealers do not dare refrain from stocking it. Conversely, the dealer or distributor restricts his own freedom to buy elsewhere when he agrees not to handle competing products, or to buy some items he would not otherwise buy; therefore, he must be in some way compelled to surrender this freedom. Ordinarily, the supplier has the bargaining power when he enjoys a partial monopoly over the supply of some particular product.<sup>34</sup> In other words, a manufacturer must use monopoly power as a lever to gain greater monopoly power if he is to make effective use of either exclusive dealing or tying contracts. Thus, the effect is substantially to lessen competition, in violation of Section 3 of the Clayton Act.<sup>35</sup>

#### *Automobile Dealers Franchise Act*

The Automobile Dealers Franchise Act,<sup>36</sup> passed by Congress in 1956, is concerned specifically with certain aspects of manufacturer-dealer relations in the automobile industry. The stated purpose of this law is "to balance the powers now heavily weighted in favor of automobile manufacturers, by enabling franchised automobile dealers to bring suits in the district courts of the United States to recover damages sustained by reason of the failure of automobile manufacturers to act in good faith in complying with the terms of franchises or in terminating or not renewing franchises with their dealers." "Good faith" is defined as the duty to act in a fair and equitable manner so as to guarantee freedom from coercion, intimidation, or threats of coercion or intimidation. This law is said to assure an automobile dealer an opportunity to secure a judicial determination, irrespective of the terms of the franchise which in the past sometimes ruled out recourse to judicial determination, as to whether an automobile manufacturer has failed to act in good faith in performing or complying with any of the provisions of his franchise or in terminating, cancelling, or not renewing his franchise.<sup>37</sup> The automobile manufacturers may find consolation in the fact that this statute also requires that the franchised dealers act in good faith.

Manufacturers in other industries, especially those making extensive use of distribution through franchised dealers, may well ponder the significance this legislation has for them. Is it a forerunner of similar statutes to come? Is it a piece of "handwriting on the wall"? Perhaps they should

<sup>34</sup> G. W. Stocking and M. W. Watkins, *Monopoly and Free Enterprise* (New York: The Twentieth Century Fund, 1951), p. 337.

<sup>35</sup> *Ibid.*, p. 383.

<sup>36</sup> 70 Stat. 1125, Chap. 1038, Secs. 1-3.

<sup>37</sup> CCH, *Trade Regulation Reporter*, Par. 9,070.

consider seriously the comments of a distinguished professor of law who wrote the following:<sup>38</sup>

No doubt arming a dealer with the power of legal complaint if his franchise is terminated without cause flies in the face of competition's traditional reliance on freedom of customer selection and rejection. But if the laws designed to enforce competition cannot prevent centers of dependence, if bargain has to such an extent given way to ultimatum, then other avenues of redress will be found.

#### *Maintaining Resale Prices in Absence of Fair Trade*

Manufacturers sometimes get into legal difficulties when they attempt to "police" resale prices of their products in areas where they do not have lawful resale price maintenance agreements in effect. For instance, a pharmaceutical company set out, in 1956, to maintain resale prices in the District of Columbia, which has never had a fair trade law, and in Virginia, which had no fair trade law at the time, by refusing to sell to those who would not cooperate. The court held that it was illegal for the company to refuse to deal with wholesalers as a method of persuading them not to supply the company's products to retailers who departed from the suggested prices.<sup>39</sup> Thus, we might generalize and say that marketers should be extremely hesitant in taking any action to force middlemen to adhere to suggested prices and especially so in the absence of legal fair trade agreements.

#### PROMOTION DECISIONS

Of all the promotion decisions, those on advertising are most affected by legal restraints. Advertising has received more attention from lawmaking bodies and enforcement agencies than has personal selling, probably because advertising exposes itself to large audiences whereas personal selling generally does not. Furthermore, advertising, whether printed or spoken, is recorded in publications and the logs of television and radio stations where it may be inspected later by public authorities. There are no such comparable records of personal selling presentations. This does not imply an absence of legal restraints on the management of salesmen. Far from it, but these particular legal restraints are so extensive and general in their application, applying to all personnel and not just to salesmen, that they are more properly treated in such books as Professor Dow Votaw's *Legal Aspects of Business Administration*.<sup>40</sup> In the following paragraphs,

<sup>38</sup> K. Brewster, Jr., "The Corporation and Economic Federalism," in E. S. Mason (Ed.), *The Corporation in Modern Society* (Cambridge: Harvard University Press, 1959), p. 77.

<sup>39</sup> *U.S. v. Parke, Davis & Co.*, 80 S. Ct. 503 (February 1960).

<sup>40</sup> D. Votaw, *Legal Aspects of Business Administration*, 2nd ed. (Englewood Cliffs, N.J.: Prentice-Hall, 1961). Especially see Part 4 on "Operating a Business."

then, the legal restraints treated are concerned mainly with advertising decisions and the closely related field of sales promotion.

### *False Advertising*

The Wheeler-Lea Act,<sup>41</sup> a 1938 amendment to the Federal Trade Commission Act of 1914, expanded the earlier law's prohibitions against "unfair methods of competition" to prohibit also "unfair or deceptive acts or practices." Under both pieces of legislation, the FTC is responsible for preventing false and deceptive advertising. The Wheeler-Lea Act specifically outlaws the dissemination of any false advertisement to induce the purchase of food, drugs, devices, or cosmetics.

The Wheeler-Lea Act also strengthened the FTC's enforcement procedures. It gives the FTC the power to obtain a temporary injunction or restraining order prohibiting the circulation of a false advertisement without the lengthy delay so characteristic of obtaining such injunctions and restraining orders. Furthermore, if the falsely-advertised product is injurious to health, the commission has the power to ask the Attorney General to initiate criminal proceedings against the advertiser.

The FTC attacks false and misleading advertising on a broad front. This is shown by its accomplishments in 1960 which included, among others, the following: complaints issued against the makers of seven well-known products who were alleged to have resorted to camera trickery or to have not disclosed significant facts in their television commercials; proceedings instituted against sellers of corneal contact lenses whose advertising claimed that any person could wear them without discomfort; actions taken against sellers of reconditioned television picture tubes whose advertising either implied or claimed the tubes were new; and attacks made on correspondence schools for engaging in misleading advertising on the general theme of money-making opportunities for graduates of such schools. Also in 1960, the FTC made progress in its effort to secure voluntary compliance with the law through issuing and giving wide distribution to a publication titled "Guides Against Deceptive Advertising of Guarantees."<sup>42</sup>

### *Bait Advertising*

Bait advertising, simply defined, is advertising under false pretenses. The FTC considers bait advertising "an alluring but insincere offer to sell a product or service which the advertiser in truth does not intend or want to sell."<sup>43</sup> Its purpose is to attract consumers interested in buying the advertised product, in order to sell them a substitute product, usually at a

<sup>41</sup> 52 Stat. 115.

<sup>42</sup> *F.T.C. News Summary*, January 12, 1961.

<sup>43</sup> 24 Federal Register 9755, December 4, 1959.



higher price or on a basis more advantageous to the advertiser. Thus, the chief aim of a bait advertisement is to obtain leads on persons interested in buying merchandise of the general type advertised. The FTC prosecutes bait advertisers as engaged in "deceptive acts" and, as part of its attempt to discourage the practice, has provided advertisers with a number of guides against bait advertising. Several states, including New York, have also enacted statutes prohibiting bait advertising.

#### *Deceptive Price Advertising*

The FTC has been especially active in seeking to prevent the advertising of deceptive prices. While the commission has prosecuted dishonest price advertisers at an ever-increasing rate, it has provided advertisers with enough of the basic ground rules to encourage widespread voluntary avoidance of deceptive price advertising practices. In 1958, the commission issued its "Guides Against Deceptive Pricing" and distributed this publication to thousands of businessmen with the cooperation of Better Business Bureaus everywhere. Typical of the practices this publication warns advertisers to avoid are these: advertising that an item is being sold at a reduced price if the former price was artificially high; advertising a special "sale" price when there has been no actual price cut from the seller's customary price nor a saving from the regular price in the trading area; advertising "two-for-one" sales unless the price for the two articles is the seller's usual retail price for the single article or its usual price in the trading area; advertising "half-price," "50% off," or "one cent" sales, unless the representation is factually true; advertising products as being sold to consumers at "factory" or "wholesale" prices unless they are actually being offered at the same price that retailers regularly pay and are less than customary retail prices for the article in the trading area; and "pre-ticketing" an article with any price figure greater than the price at which the article is usually sold in the area where the product is offered for sale.

Most deceptive price advertising has been by middlemen rather than by manufacturers. However, some manufacturers, occasionally at least, have made it easy for retailers to "fall into" deceptive price advertising practices. One, for instance, put a "list price" of \$79 on a piece of shop equipment when, in actuality, retailers bought the item at \$6.95 and sold it at \$9.95. A second offered dealers their choice of several price tags for the same product in order that they might tailor their discount policies to the local competition. A third advertised his product nationally at a list price of \$119.95, but priced it at \$65 to dealers, nearly all of whom sold the product at prices under \$100. According to the Federal Trade Commission, the law is being violated whenever the term "list price" is used to mean anything but the usual price at which the product is sold at retail. The

same applies to other terms such as "manufacturer's suggested retail price," "catalog price," and "nationally advertised price."

#### *Promotional Allowances and Services*

Sections 2(d) and 2(e) of the Robinson-Patman Act are concerned with the conditions under which a manufacturer may pay promotional allowances or provide promotional services to competing dealers. Section 2(d) provides that if a customer is offered an allowance, a discount, or some other form of compensation for displaying, handling, advertising, or otherwise promoting a product, then that same payment or consideration must be made available on *proportionally equal terms* to all other customers competing in the product's distribution. Thus, if a manufacturer offers to share the cost of newspaper advertising with a particular retailer on a 50-50 basis, to comply with the law he must devise some means of making the same offer available on proportionally equal terms to all other customers who compete with that particular retailer. Section 2(e) provides that if the seller furnishes one customer with services (e.g., a retail clerk employed by the seller but working in the customer's store) or facilities (e.g., a special display fixture), then the seller must make a similar offer available on proportionally equal terms to all competing customers.

These two provisions of the Robinson-Patman Act have presented manufacturers with some difficult problems. For instance, an effective promotional device for a meat packer may be to use an in-store demonstrator for purposes of sampling his smoked sausages in the larger chain store supermarkets, but how can the demonstrator's services be made available on proportionally equal terms to all customers competing with these supermarkets? One possibility is to apportion the demonstrator's time according to the relative purchases of each competing customer, but this might mean too little time (e.g., five minutes) in some stores and too much (e.g., several days or weeks) in others. Another possibility is to offer some substitute service to smaller customers, but this leaves unanswered, and subject to easy challenge, the question of equating proportionally the values of the service and its substitute. The FTC, in an effort to make compliance less difficult, has issued "guides" defining the main terms of Sections 2(d) and 2(e) and illustrating acceptable and nonacceptable plans for providing promotional allowances and services.

#### *Use of "PM's"*

In some fields, in the hosiery and glove business, for example, it is fairly common for manufacturers to pay PM's—variously interpreted as "premium money" or "push money"—to retailers' clerks. For instance, a hosiery manufacturer's salesmen may arrange to pay retail clerks a dime for every pair of the brand they sell in a given period. As long as the man-

ufacturer informs the clerks' employers in advance and obtains their consent, there is nothing illegal about this arrangement. In the eyes of the FTC, it is an unfair competitive practice for a manufacturer to reward clerks for sales of his goods without the knowledge and consent of their employer.

### CONCLUSION

From the standpoint of the marketing decision-maker, the law is a major uncontrollable factor limiting the power of decision. Unlike other uncontrollables—economic, psychological, and sociological—the law operates mainly to limit decision; rarely does it provide opportunities to be capitalized on through marketing action. Some legal restraints, such as those outlawing bait advertising or the cutting off of a competitor's source of supply, are merely formal prohibitions of actions and tactics which ethical businessmen would avoid anyway. Unfortunately, however, not all legal restraints are of this kind. Far from being clear-cut prohibitions, most leave an ill-defined and uncertain boundary between what is legal and what is not. For example, decisions involving expansion must be made with the knowledge that they may later be declared illegal. Other decisions, such as those requiring cooperative relations with competitors, may not always be illegal—but they are risky for they may lead to antitrust prosecution. Society seems to be working toward the ideal of maintaining and, if possible, extending a highly competitive business system. Imperfections in the system, if not self-correcting, tend to become the targets of legislative action and judicial interpretation and not always with results which contribute to achievement of the ideal. Most legal restraints, then, form a significant portion of the environment of uncertainty within which many important marketing decisions must be made.

### QUESTIONS AND PROBLEMS

1. "Business competition serves as a sort of natural protector of the public interest." If this is so, why have legal restraints on marketing decisions been imposed?
2. Explain the significance of the "share-of-the-market" concept in legal actions involving corporate mergers. What are the implications, if any, of the legal aspects of this concept with respect to a company's marketing research activities?
3. Do you favor or oppose Mr. Romney's proposal that when one firm in a basic industry gains more than a certain per-

centage of total industry sales it should be required to file a plan of divestiture bringing its share-of-the-market below some specified level? Why?

4. Explain the meaning of the following terms:
  - a. monopoly power
  - b. basing-point system
  - c. style piracy
  - d. generic name
  - e. functional discount
  - f. dummy brokerage payment
5. Differentiate among the following types of mergers and consolidations: horizontal, vertical, and conglomerate. What are the marketing justifications, if any, for each type of merger?
6. One part of the policy manual of a large corporation reads as follows:

It is the policy of the company to comply strictly in all respects with the anti-trust laws. There shall be no exception to this policy nor shall it be compromised or qualified by anyone acting for or on behalf of the company. No employee shall enter into any understanding, agreement, plan or scheme, expressed or implied, formal or informal, with any competitor, in regard to prices, terms or conditions of sale, production, distribution, territories or customers; nor exchange or discuss with a competitor prices, terms or conditions of sale or any other competitive information; nor engage in any other conduct which in the opinion of the company's counsel violates any of the antitrust laws.

Should such a formal written statement of policy on compliance with the law be necessary? Why or why not?

7. "The law prohibits price discrimination, but it does permit certain differentials in price." Explain.
8. What is meant by the "good faith" defense?
9. Distinguish between non-cumulative and cumulative quantity discounts. If a company wants to minimize the risk of being charged with price discrimination, which type of quantity discount should it use? Why?
10. Under what conditions are functional discounts likely to be held legal? Illegal?
11. Why should it be illegal (as it is) for buyers to induce or knowingly receive the benefits of price discrimination?
12. The resale price maintenance laws are often called the "fair trade" laws. What is "fair" about them?

13. Do you favor the "nonsigners' clause" permitted by many state fair trade laws? Why or why not?
14. Explain the cash discount theory of trading stamps. Analyze the significance of this theory for the manufacturer whose products are fair-traded.
15. Compare and contrast the fair trade laws with the unfair trade practices acts.
16. What is meant by exclusive dealing? Tying contracts? Under what circumstances is it legal for a manufacturer to use such devices?
17. Analyze the extent to which the law imposes restraints upon a manufacturer's choice of channels of distribution and the conduct of his relationships with middlemen.
18. Can a manufacturer legally refuse to deal with middlemen who do not agree to maintain resale prices? Under what circumstances?
19. Legal restraints appear to affect advertising decisions more than they do personal-selling decisions. Why?
20. Differentiate among the following: false advertising, bait advertising, deceptive price advertising.
21. Under what circumstances may a manufacturer pay promotional allowances or provide promotional services to dealers?
22. The Food and Drug Administration has published official grade definitions for most canned fruits and vegetables, but packers are not required to affix the official grade designation to their products. Would you favor making it compulsory for all packers to affix these official grades to their products? Why or why not?
23. Prepare a short paper appraising the extent to which the different types of legal restraints on marketing strengthen or weaken the position of consumers as participants in the economic process.

# **PART THREE**

# **Marketing Decision-Making**

MARKETING MANAGEMENT AND DECISION-MAKING

OPERATING DATA FOR MARKETING DECISIONS

MARKETING RESEARCH

MARKET MEASUREMENT AND FORECASTING

# MARKETING MANAGEMENT AND DECISION-MAKING

## 11

In previous discussion we have attempted to provide the foundations on which to build an analysis of marketing management and decision-making. Part One furnished background information needed for an understanding of marketing and marketing problems. There we discussed such basic topics as markets, products, functions, and institutions. Part Two surveyed the external marketing environment which, from the standpoint of the marketing decision-maker, is composed of many complex factors interacting and influencing market demand. Capsule reviews were provided of those economic, psychological, sociological, and legal factors which, even though they



cannot be controlled by individual firms, must be taken into account by marketing decision-makers. We have already referred, in these earlier chapters, to certain problems of marketing management and decision-making, but this was mainly to help point out the significance to marketing of the topics then under consideration. Throughout the remainder of this book, our discussion and analysis will be addressed directly to problems of marketing management and decision-making.

### WHAT IS MANAGEMENT?

Management is the direction of purposeful activities toward the attainment of pre-established goals. Notice that management *directs*, makes things happen—it does not merely drift with the tide. Notice also, that the activities management directs are *purposeful* ones, consciously planned, organized, coordinated, and controlled. Notice further that managerial effort is *goal-directed effort*. Management, if it is worthy of the name, “knows where it is going.”

Management's chief concern is with activities. Some writers contend that management “manages people” and not activities. Our view is that although management must be concerned with people, it must be most concerned with what people *do*. Management must use people to perform the activities required in the effort to reach goals. A similar line of reasoning applies to the management of money—management is not so much interested in money as it is in what money can do. Nor does management manage land, capital equipment, or anything else *as such*. Management directs the activities that the so-called “factors of production” are capable of performing.

Management is accomplished through planning, organizing, coordinating, and controlling. All executive positions are alike. Differences among executive positions are largely differences in the relative emphasis given to each of the four management functions. Planning, organizing, coordinating, and controlling functions are performed by both high-level and low-level executives, by both the company president and the district sales manager, for example. But the president will usually have to emphasize the planning function a good deal more than the district sales manager will; on the other hand, the district sales manager will spend much more time on organizing duties than the president will.

Executive positions also differ with respect to the areas in which decisions are made. Marketing executives make marketing decisions, and executives in other departments make decisions within their own jurisdictions. But there are decision problems which affect the operations of more than a single department. If, for example, a chief marketing executive decides that a new product is needed, there are direct and important implications in that decision for production, personnel, and research and

development departments, and naturally for general management as well. In all cases, whether or not a problem has cross-departmental implications, an executive must have planning, organizing, coordinating, and controlling skills in order to make appropriate and intelligent decisions.

#### WHAT IS MARKETING MANAGEMENT?

A branch of the broad area of management, marketing management is concerned with the direction of purposeful activities toward the attainment of marketing goals. Sales volume, net profits, and growth in sales volume and profits are the three main marketing goals and, certainly, these are also the main goals of the company as a whole. Marketing management, in other words, is accountable to top management for initiating and maintaining sales income, for adjusting sales volume and expenses so that profits will result, and for seeing to it that the business grows. Even without management, there would still be marketing in the sense that products would in some way find their ways to markets. But it is very likely that such a passive approach would result in small sales volumes and few profits. Despite the excellence of a product, its chances of ever being sold in volume at a satisfactory profit are small if its maker lacks essential management skills. Modern marketing managers cannot wait passively for marketing to "just happen." They must make it happen.

The term "marketing management" is used more often in referring to the marketing operations of manufacturers than to those of middlemen. The main reason for this is that marketing managers in manufacturing and other producing enterprises manage and make decisions on a wider variety of marketing-type activities. Marketing managers in manufacturing firms are concerned with such matters as the marketing organization, products, brands, distribution channels, physical distribution, pricing, advertising, and personal selling. These are the matters about which marketing managers in all "make and sell" businesses make decisions. Managers in wholesale and retail firms, in other words those in "buy and sell" businesses, make some decisions which parallel those of the manufacturer's marketing manager. In retailing, for example, decisions must be made on store organization, merchandise handled, brand policy, pricing, advertising, and personal selling. But the retailer makes no decisions comparable to those the manufacturer makes on distribution channels and many phases of physical distribution. Furthermore, whereas middlemen make many decisions on such essentially non-marketing problems as those of financial structure, organization of non-selling personnel, store design, and store equipment, the marketing manager in a manufacturing firm devotes himself almost exclusively to managing purely

marketing-type activities. Regardless of these differences found on different levels of distribution, marketing management is still concerned with directing purposeful activities in order to reach marketing goals. All marketing managers necessarily perform the managerial functions of planning, organizing, coordinating, and controlling. The general nature of these functions, as they relate to the marketing manager's work, is discussed below.

### **Planning**

A marketing manager must have highly-developed planning skills. In a manufacturing firm, for example, he cooperates with other executives in setting goals for the company as a whole. Many of these are marketing-type goals and are expressed in such terms as *planned sales volume* and *expected net profit*. Not only does he help decide how much sales volume and net profit the firm should anticipate, he assumes major responsibility for "making these figures come true." It is his duty to plan "how the company is going to get from where it is to where it wants to go." Furthermore, he is the planner who decides whether and how each goal, e.g., planned sales volume, should be divided into sub-goals for individual products, specific marketing areas, definite time intervals, segments of the marketing organization, and so on. Considering the company's capabilities and each of his subordinates' strengths and limitations, he parcels out the responsibilities for reaching these sub-goals.

### **Organizing**

A marketing manager needs organizing skills if he is to be able to design the most appropriate organization for achieving the assigned goals. He must make certain that marketing plans are compatible with departmental policies already in effect, and that these plans are the ones best fitted for achieving the marketing goals. Under his direction and guidance, promotional programs and campaigns are drafted, marketing methods and procedures are set up, and other decisions are made in order to execute the policies and implement the marketing plans. For effective discharge of these responsibilities, a marketing manager needs great skill both in planning and in organizing.

### **Coordinating**

Whether in manufacturing, wholesaling, or retailing, a marketing manager must have coordinating skill. A marketing manager in a manufacturing company not only must coordinate the work of his different subordinates, he must coordinate his own efforts with those of executives in other departments—manufacturing, personnel, finance, and others.

He must coordinate advertising plans with selling plans, and both of these with manufacturing schedules and plans for physical distribution of the goods for sale. He must coordinate the manufacturer's promotional efforts with those of the middlemen handling the product. These are but a few of the many situations where a marketing manager needs coordinating skill.

A marketing manager's need for skill in coordination is further emphasized by his place in the firm's organizational structure. In retailing and wholesaling, marketing managers, whatever their formal titles, are *the* top-management people—they are the chief executives. Marketing managers in manufacturing firms are ordinarily not located at the very top of the organizational structure. Generally they are subordinate to the president or executive vice-president and, as such, are considered associates of the top-management team, rather than top-management itself (as they usually are in wholesaling and retailing). The marketing manager's subordinates are specialists—the sales manager, advertising manager, sales promotion manager, director of marketing research, and sometimes others such as a new products manager, distribution and warehousing manager, and credit manager. He is responsible for coordinating the efforts and activities of all these subordinates. In large companies manufacturing many different products, there are often several marketing managers, each charged with directing marketing activities for some product or line of products. In these situations, the efforts of the different marketing managers are coordinated on an over-all company-wide basis by a marketing vice-president.

### Controlling

Effective marketing managers also need skill in controlling. There are four phases of the controlling function: (1) establishment of performance standards, (2) measurement and "feedback" of performance results, (3) evaluation of actual performance against the standards, and (4) the taking of action as indicated by the evaluation. When, for example, a marketing manager assigns sales and profit goals to subordinates, he is establishing standards against which he can later appraise their performance. If a subordinate's performance does not measure up to standard, the marketing manager tries to determine the extent to which the variation was caused by factors both beyond and within the subordinate's control. Depending on the outcome of this evaluation, the marketing manager decides on appropriate actions. The primary purpose, then, of any system of controls is to set the stage for decision and action.<sup>1</sup> Effec-

tive control keeps the organization "on course" as marketing management steers toward the company's set goals.

### BASIC PROBLEM OF MARKETING MANAGEMENT

Marketing management's basic problem is to adjust the forces under its control within an environment composed of diverse and ever-changing forces outside its control. These forces are known, respectively, as the *controllables* and the *uncontrollables*. The uncontrollables, which were reviewed in Part Two, consist in the main of those economic, social, psychological, and legal phenomena which the individual firm can influence only indirectly if at all. The controllables can be directly influenced by decisions and actions of the individual firm and include such factors as the marketing organization, products, brands, distribution channels, physical distribution, pricing, advertising, and personal selling. Marketing management seeks to manipulate the controllables in terms of the uncontrollables in such ways as result in sales volume, profit, and long-term business growth. As management plans, organizes, coordinates, and controls the application and the adjustment of the controllables, it must also keep the uncontrollables in mind. Collectively, the uncontrollables make up the environment in which the firm must operate, while the controllables are the means by which the firm adapts itself to that environment.

For the marketing manager, the uncontrollables include such factors as the amount of consumers' disposable income, the distribution of that income and the propensity of consumers to spend it, the trend of fashion, the psychological peculiarities and behavior patterns of present and prospective buyers, and the substance and judicial interpretation of the law. We have previously identified all these as uncontrollables, but there are still other factors which the marketing manager must take into account in his decision-making but which are largely beyond his power to control. While he has some freedom in selecting distribution channels, for example, he has little or no control over the structure of the distribution complex—i.e., the types of middlemen, their numbers and locations, their operating characteristics, and their relationships with each other and with various markets. His decision on distribution channels, therefore, is limited by the different combinations of existing types of middlemen that can be (and are willing to be) joined together for that purpose. Furthermore, there are certain factors within the firm itself which are not under the marketing manager's direct control. He can, for example, exert only indirect influences over production costs and general administrative expenses, yet both are highly relevant in making decisions on prices. This last example, of course, merely re-emphasizes

the point that the marketing manager needs skill in coordinating marketing decisions and actions with those made elsewhere in the company.

Although the marketing manager can exercise little, if any, influence over the uncontrollables, this in no way lessens their importance to him. As he makes decisions on such controllables as prices, products, the sales force, and advertising, the uncontrollables limit the range of possible and appropriate decisions. At the same time, the interactions of uncontrollable forces often provide an alert marketing manager with opportunities for making profitable readjustments of the controllables. A shift in the distribution of consumer income resulting in increased leisure time for more people, for example, may suggest the need for a new product, or for a change in advertising or distribution policy. Dynamic marketing management is characterized by continual adjustment and readjustment of controllables in relation to uncontrollables, which make up the environment.

These adjustments must be so made that opportunities inherent in the environment are capitalized upon as far as possible. Marketing management's responsibility is to make these adjustments, i.e., to direct purposeful activities, in such ways as to facilitate the achievement of marketing goals. Working within an environment of uncontrollables, marketing management directs the application of controllables, and it does this through planning, organizing, coordinating, and controlling.

#### MARKETING DECISION-MAKING

In directing purposeful activities toward the achievement of marketing goals, marketing management must make decisions and carry them out. A marketing manager must be able to recognize problem situations, determine possible alternative solutions, appraise alternatives, and select the most appropriate ones. Finally, he must be capable of taking action. Thus, decision-making is the process which results in the choice of a course of action with respect to what should or should not be done in a given problem situation. A decision, therefore, can be defined as the particular course of action chosen by a decision-maker as the most effective means at his disposal for achieving the goal or goals he is currently emphasizing, or for solving the problem that is bothering him.<sup>2</sup>

Decisions may be made either with a minimum of forethought, or after considerable analysis and deliberation. The first class of decisions, those made quickly, are known as intuitive decisions. The second class, those made only after a great deal of analysis and deliberation, are called rational decisions.

*Intuitive Decision-Making*

Not every problem situation is important enough to justify the rigorous analysis and lengthy deliberation needed for rational decision-making. A supermarket manager, for example, cannot spend much time deciding whether to stock one or two dozen crates of tomatoes for his weekend trade. And then there are problem situations so serious that decisions must be made at once—before the problems get worse. A swimsuit manufacturer, for example, caught with an unexpectedly large inventory near the season's end, cannot delay his decision—the longer he waits, the worse the problem gets. And, even if a marketing executive could consider *all* problems before they became serious, the sheer number of decisions required would force him to make most of them intuitively. In short, most decisions are made intuitively—in marketing and elsewhere in business.

In making an intuitive decision, an executive does not draw solely on his "intuition." As far as possible, he draws on his previous experience and his knowledge of similar problem situations, combining common sense and judgment. Certainly, many of his experiences with similar situations may have had their own peculiarities, and the same can be said about what he knows of how others have handled similar problems, but the significant point here is that an intuitive decision is rarely a pure guess. Only when there is no information whatever is an intuitive decision based wholly on "hunches," and "feelings as to what is best."

Considerations of time and expense may force the marketing manager to make many of his decisions intuitively, but he should try, as far as possible, to confine his intuitive decision-making to relatively unimportant matters. Minor decisions such as "should we hold our regular weekly sales meetings on Mondays or Fridays" can certainly be made without a great deal of analysis or deliberation. If the decision is in favor of Mondays and it later turns out that Fridays would have been a better choice, the decision can easily be changed. Similarly, the decision-maker can deal with many routine questions as they arise, as he can, for example, in determining whether or not to renew the office's subscription to *Business Week*—not much money "rides on" this decision and, regardless of the decision he makes, he can always reverse it later. All minor decisions are alike in that their consequences, financial and otherwise, are not particularly important, and it is relatively easy to change them if that becomes necessary. Clearly, the implication here is that a marketing manager must be able to discriminate between major and minor problem situations requiring decisions. Such discrimination involves assessments of possible consequences and estimates of the ease with which

decisions can be changed—mental processes calling for considerable judgment and keen insight.

### *Rational Decision-Making*

Rational decision-making should be used in all major marketing problem situations. Major marketing problems are characterized by two things: (1) because they arise at irregular intervals, decisions on them should not have to be made very often; and (2) they have important consequences which must be lived with for a long time as it is extremely difficult and "awkward" to change such a decision once it is made. Major marketing problems may involve the introduction of new products, opening up new markets, changing the basic structure of sales organizations, choosing distribution channels, and determining the types and amounts of personal selling and advertising and other promotional elements in "marketing mixes." The consequences of decisions on major marketing problems also commonly affect not only marketing operations but those of other departments. For instance, the decision to introduce a new product, as noted earlier in this chapter not only has consequences for the marketing department but directly affects the production department and may significantly influence such departments as personnel, finance, purchasing, engineering, and accounting. Therefore, another earmark of many major marketing problems is that decisions on them have important consequences across departmental lines. Decisions on major marketing problems are highly critical ones, then, and should be reached only after thorough analyses and serious deliberations. Their possible consequences are of such high and far reaching importance that a marketing executive cannot risk making them intuitively.

How does a marketing executive make a rational decision? We have already said that thorough analysis and serious deliberation precedes the making of a rational decision, but what sort of analysis and deliberation? Although quick answers to these questions are impossible, we can say that rational decision-making requires rather formal patterns of thinking and logical approaches to problem-solving. To shed further light on rational decision-making, we must first review some economic theory. Afterwards, we will address ourselves directly to the question of how a marketing executive goes about making rational decisions.

**DECISION-MAKING BY "ECONOMIC MAN."** The concept of "economic man," borrowed from traditional economic theory, furnishes the basis for what is now called the "theory of decision-making under certainty." The assumptions made about economic man are that he is fully informed about all problem situations he encounters; he knows all the alternative



solutions that are open to him; he absolutely knows the consequences (or outcome) of each alternative; he makes wholly "rational" decisions. Economic man has more than just complete information about all the problems he meets; an important side-assumption makes him even more fortunate—each alternative solution has only *one outcome*, or set of consequences, and it is *certain*. Thus, economic man is also blessed with perfect foresight—he can predict the consequences of his decisions with absolute accuracy.

Armed with complete information and perfect foresight, economic man proceeds to make fully rational decisions. These fully rational decisions are possible because of two other assumptions made about economic man's behavior. The first such assumption is that he can *weakly order* alternative solutions according to the desirability of their outcomes. By "weak ordering," we mean that presented with any two sets of consequences, or outcomes, call them A and B, economic man can tell whether he prefers A to B, B to A, or is indifferent to them. Implicit in the notion of "weak ordering" is the idea that economic man can state his preferences but may not necessarily be able to determine *how much more* he prefers his first choice to his second choice, his second to his third, and so on. However, economic man is consistent in all of his preferences—if he prefers A to B and B to C, then he also prefers A to C. The second assumption which makes economic man's rational decision-making possible is that he always chooses that alternative which will maximize whatever it is that he considers desirable. Writers have differed on the "something" that economic man maximizes in his decision-making. Bentham (1748-1832) believed that economic man made decisions in order either to maximize pleasure or minimize pain. Bentham's successors, including such great economists as Gossen, Walras, Jevons, Menger, and Alfred Marshall, variously assumed that economic man made decisions in such ways as "to maximize satisfaction," "to maximize utility," or to "maximize net gains."

Although actual marketing decisions are never made under conditions of certainty, the theory does contain some helpful hints for the "real world" decision-maker. For one thing, it points up the importance of having as much information as possible about the problem situation. For another, the theory suggests that the ability to predict the consequences of alternative courses of action is a definite help in making good decisions. There is the notion, too, that the decision-maker should be able to state his preferences, i.e., weakly order the consequences of different alternatives and make his choice in line with his goal, i.e., in order to maximize something. The theory implies, then, that the marketing decision-maker should, when confronted with a problem, evaluate alterna-

tive solutions in terms of what they will contribute to the marketing goal he is currently emphasizing, and make his choice accordingly.

**REQUIREMENTS FOR RATIONAL DECISION-MAKING.** What must a decision-maker have in order to make rational decisions? First, he must be able to clearly conceptualize specific problem situations. A decision-maker cannot reach an intelligent decision unless he has the problem "sized-up" accurately—he has to know what the problem is in order to solve it. Second, he needs pertinent, factual information about the problem and must be capable of using it in his analysis—both rational and intuitive decisions are more likely to turn out right the more they are based on "facts." And, the decision-maker must be able to predict the possible consequences of each alternative solution or course of action. Therefore, conceptualization, information, and prediction are three main keys to rational decision-making. Later we will discuss these keys more fully but, for now, notice what happens when we turn these key requirements around—we have the excuses executives come up with when they attempt to defend an intuitive decision made in a major problem situation. (1) "It's difficult to conceptualize this problem" and "this problem is hard to describe." (2) "We don't have enough pertinent and reliable information about this question" or "we don't have the facts we need," and (3) "It's hard to tell what to predict" and "nobody knows what will happen."

**UNCERTAINTY AND RISK.** Decisions on major marketing problems are always made in the face of uncertainty. Marketing decisions are, of course, made for the future, and marketing executives—unlike "economic man"—have yet to find a way of predicting the future with absolute certainty. The decision-making environment in marketing is one of diverse and ever-changing uncontrollable forces interacting in complex ways, and this makes prediction difficult. The consequences of alternative courses are rarely so certain and so clear-cut that the best ones can be selected with absolutely no risk of being wrong. And there are almost always some variables in marketing problems about which the decision-maker has little or no information, and rarely does he have enough time to investigate them all exhaustively. Even if there were sufficient time to gather complete information, the great expense involved would certainly outweigh any benefits that might come from such maximum reduction of uncertainty. We must realize that having *all* the facts does *not* mean the elimination of uncertainty, but only that the chances of accurate prediction are better than with less complete information. What an executive needs is information that is complete enough for him to be able to conceptualize the problem clearly, and to make reasonably ac-

curate predictions of the likely consequences of alternative solutions. Lack of *this* much information often leads to faulty conceptualizations of problems and to compounding errors in predictions.

Through the use of electronic data processing and modern research techniques, progress is being made in supplying today's marketing executive with many facts and figures which were once considered impossible or too expensive to obtain. But as brought out above, marketing decisions are still made in the face of uncertainty and probably always will be. The marketing decision-maker needs not only to recognize the existence of uncertainties but that there is always some risk that his decisions will be in error.

The "trick" seems to be in estimating just how much risk there is in each alternative solution to a given problem. Decisions are made more readily and with more confidence when an executive can think of them as *calculated risks*, rather than as "blind stabs in the dark." Since in marketing decision-making there is no such thing as capitalizing on absolute certainties, an executive can at least strive to make his decisions calculated risks. Ideally, a marketing decision-maker should have a quantitative expression of the likely effects of the uncertainties present in a problem; as, for example, the probable changes that some event will or will not occur.<sup>3</sup> Additional light will be shed on this aspect of marketing decision-making later on in this chapter.

#### *Problem Identification and Conceptualization*

Marketing executives almost unanimously agree that most problems are harder to identify than to solve. They say "problems hardly ever come clearly labeled as such—the executive must be perceptive enough to smell them out." In fact, it is so rare in business for everything to go smoothly that, when this happens, executives begin to worry that something has gone wrong without their knowing it. Clearly, executives cannot deal with problems, i.e., make decisions on them, until they become aware of them and are able to conceptualize their nature.

How does an executive go about recognizing and identifying problem situations? Probably the most promising approach is to search for situations where performance is capable of being improved. If there is some way of measuring performance and of appraising it against some standard, this should be a highly effective method for identifying problem situations. But standards may be wrong; the setting of standards for appraising marketing performance is still far from being an exact sci-

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<sup>3</sup> For an explanation and illustration of a method used for deriving and quantifying probability figures of this sort, see: C. W. Churchman, R. L. Ackoff, and E. L. Arnoff, *Introduction to Operations Research* (New York: John Wiley & Sons, 1957), pp. 559-573.

ence. Standards that are wrong, set either too high or too low, may be worse than *no* standards at all. But, if a company has a good system of control—where performance standards are well-defined, where there are efficient methods of recording and reporting actual performance, and where executives make intelligent use of these standards in evaluating performance—the search for situations requiring decision and action is greatly facilitated.

Unfortunately, even the best control system does not call attention to every problem. Quite often, an executive must know about problems that are still germinating and which have not yet become serious enough to be picked up by the control system. This suggests that marketing decision-makers need something similar to the diagnostic skill of a medical doctor. Because a patient doesn't feel well and suspects that something may be wrong, he visits a doctor. Through skillful examination, questioning, and interpretation of the symptoms the doctor tries to uncover the trouble. When specific symptoms are present in given combinations, the doctor's education and experience enable him to calculate the chances that the patient has certain ailments and he makes his identification accordingly. A marketing decision-maker also has to be something of a diagnostician. He must be skilled not only in recognizing the symptoms of existing problems, but also in heading off problems-to-be. In this latter respect, marketing decision-makers are in a sense practicing "preventive medicine"—in attempting to anticipate problems, and in making and implementing appropriate decisions before problems arise or at least before they become serious.

Like a medical doctor, a marketing decision-maker needs to have access to information about the problem situation. If he is to correctly conceptualize the problem, he must be capable of asking the right questions of those who have pertinent information to give. He must also be a keen analyst of the information he already has, and of that which is especially gathered to shed light on the problem. In other words, a decision-maker requires skills both in examining what he suspects is a problem situation and in analyzing the available facts pertaining to it.

Thus, for both the medical doctor and the business decision-maker, problems exist only in the context that something "is not functioning properly" or "is about to malfunction." Therefore, there must be some concept of what constitutes proper functioning. When a decision-maker meets a problem, he knows it is a problem either because of warnings flashed by the management control system or, more frequently, because of his skill as a diagnostician. In perceiving problem situations requiring decisions, an executive must constantly rely on his understanding of and "feel for" the norms, standards, or goals relative to which a situation can be identified as a problem.

**Logical Analysis of Problem Situations**

Earlier we summed up the three key requirements of rational decision-making in the words *conceptualization*, *information*, and *prediction*. The preceding section was mainly concerned with problem identification and was only a preliminary explanation of the part played by conceptualization in rational decision-making. The important role of conceptualization will become increasingly clear as we examine the details of different marketing problem situations, especially those discussed in Part Four of this book. For now, however, it is sufficient to think of conceptualization as being the way an executive visualizes or "sees" a particular problem requiring him to make a decision. But we should not forget the point made a few pages back that an executive needs *information* in order to identify and conceptualize problems accurately. Nor should we overlook another important point previously made—that an executive also needs information complete enough for him to be able to *predict* the likely consequences of alternative solutions with reasonable accuracy. Information, in other words, is needed for both problem conceptualization and prediction. The roles played by information and prediction in the process of rational decision-making will be further clarified in the following discussion.

The rational decision-making process involves logical analysis of the problem situation. According to two well-known management consultants, there are four steps in any logical analysis of a business problem: <sup>4</sup>

1. Recognize, define, and list all available alternatives. (There is no problem, if there aren't at least two alternatives.)
2. Select a means of measuring each alternative in terms of desired results. (We call this the "decision criterion.")
3. Forecast the results of each alternative in terms of the decision criterion.
4. Construct a "decision rule," by which the most attractive results can be identified and thus the most desirable alternative selected.

Notice how closely these steps resemble economic man's decision-making procedure. Economic man knows all the alternatives; step one tells the real life decision-maker to strive for the same knowledge. Economic man weakly orders alternatives according to the desirability of their outcomes and predicts (forecasts) these outcomes; steps two and three ask the real life decision-maker to do the same thing. Finally, economic man always chooses an alternative according to a decision rule that seeks to maximize the desirability of the outcome, and the business

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<sup>4</sup> R. E. Ball and A. A. Gilbert, "How to Quantify Decision-Making," *Business Horizons*, Vol. 1, No. 1 (Winter 1958), pp. 73-79.

decision-maker is advised to provide himself with such a decision rule in step four.

Logical analysis of a problem situation starts with the development of alternative solutions or courses of action. The quality of the decision that will result from application of the four-step procedure outlined above depends largely on the executive's success in recognizing all the feasible alternatives. Little advice, unfortunately, can be offered as to "a best way" of formulating alternative solutions to marketing problems. But we can say that alternative solutions are found mainly through the application of "ingenuity" in analyzing a problem. Some alternatives are obvious, but others are much less so. Experience with similar and related problem situations helps, and so does knowledge of marketing in general and of how others have dealt with similar problems. But ingenuity consists of much more than just relying on past experience and imitating other decision-makers. One source suggests another extremely important ingredient of ingenuity:<sup>5</sup>

We need fresh, original, distinctive, and independent thinking to develop alternatives that are neither copied from the past nor from our neighbor, but are original and peculiarly adapted to the circumstances at hand.

So, applying ingenuity in the search for alternative solutions requires that an executive be creative. Past experience, although helpful is not enough, since what were appropriate solutions to yesterday's problems may not be appropriate to today's. Nor can a decision-maker safely imitate the solutions to similar problems adopted by others, for every company is to some extent unique. Thus, two companies with "similar" problems often arrive at quite different solutions, if each chooses the most appropriate solution for its particular set of circumstances. In developing alternatives, an executive must try very hard to be creative in his thinking and outlook—he should be critical of stereotyped solutions and look for ones that are uniquely suited for dealing with the problem at hand.

#### *Marketing Goals, Decision Criteria, and Decision Rules*

Management consists of goal-directed effort and, in many respects, this fact clears away much of the mystery in marketing decision-making. The goals management strives to reach or those implicit in given problem situations are the sources of the criteria according to which alternative courses of action can be determined and appraised. Decision criteria are, in short, derived from marketing goals. Applying these criteria to alterna-

<sup>5</sup> W. H. Newman and C. E. Summer, Jr., *The Process of Management* (Englewood Cliffs, N.J.: Prentice-Hall, 1961), p. 278.

tive solutions is management's method of weighing the relative appropriateness of each proposed solution. Suppose, for example, that a marketing executive must choose between two possible prices for a product. How should he decide which to use? In making this pricing decision, he needs both a *decision criterion* and a *decision rule*. Probably the best decision criterion in this instance would be that of profit, and the executive would *predict* the effects on profit of selling the product at each of the proposed prices. His decision rule would probably be to select the price which he predicts will contribute the most to profit. Notice that the profit decision criterion and rule derive directly from the profit goal of marketing management.

**PROFIT.** The use of profit as a criterion and a rule for marketing decision-making merits further consideration. Which profit do we mean? Short-run, long-run, or what? The answer is "optimum dollar profit." This is defined as the dollar profit which provides maximum returns over the long-run. Hence, long-run dollar profit is the decision criterion and maximum long-run dollar profit is the decision rule which marketing management should apply in the logical analysis of most major marketing decisions.

Using long-run dollar profit as the main decision criterion and maximum long-run dollar profit as the main decision rule tends to put the analysis of major marketing problems into proper perspective. If a marketing manager views problem situations in this light, he is far more likely to consider them rationally and to avoid making rash or unwise decisions. He is more apt to consider the relevant factors bearing on such decisions. He avoids looking at the probable effect on sales volume or on costs separate from their effects on long-run dollar profit. He avoids, too, the all too common pitfall of thinking of present profits apart from future profits. By focusing on long-run dollar profit, the marketing manager forces himself to think in terms of relationships. He considers the relationship of sales volume to costs and the relationship of both of these to short-run dollar profits and to long-run dollar profits. This is the proper perspective for rational decision-making in marketing.

**SALES VOLUME.** The sales volume goal of marketing management provides another decision criterion and rule, but the modern marketing manager looks upon sales volume more as a necessary preliminary to the earning of dollar profit than as a marketing goal of overriding importance. The old-style "sales manager" emphasized sales volume for its own sake. The modern marketing manager still wants sales volume but, in contrast, he wants it to be made up of those sales which eventually will result in maximum long-run dollar profit. Note carefully we are *not* saying that the

sales volume goal is unimportant. Dollar profits are impossible unless there are also dollar sales, and a certain minimum level of sales volume is needed in any company in order for it to reach efficient and profitable levels of production and marketing activity. Maximum long-run dollar profit may be at the very top of the hierarchy of marketing goals, but the sales volume goal is only one step below.

**GROWTH.** The growth goal is the source of another decision criterion and rule but, like the sales volume goal, it is below long-run dollar profit in the hierarchy of marketing goals. When growth is used as a decision criterion and rule, marketing management generally has in mind "long-run growth in dollar profit." The reader will recognize that this is *almost* equivalent to using maximum long-run dollar profit as the criterion and rule. A moment's reflection, however, reveals that it is possible for a firm to maximize long-run dollar profit and not have any long-run growth in dollar profit at all. If the general trend of business is unfavorable, therefore, growth is a questionable criterion and rule for decision-making. Similarly, it is inappropriate to use the growth criterion and rule in making marketing decisions when a company operates in a declining industry unless, of course, growth is used in the sense of minimizing shrinkage in long-run profits. Growth is most appropriately used as a decision criterion and rule in companies that are parts of true "growth industries"—ones whose sales and profits are growing far more rapidly than the economy as a whole. Even in these cases, though, the use of long-run dollar profit should put the situation requiring decision into a more proper perspective.

**SHARE-OF-THE-MARKET.** Companies occasionally set marketing goals other than those of profit, sales volume, and growth. These give rise to additional decision criteria and rules. Some top-managements, for example, strive first and foremost for a specified share of the total industry's sales. In such companies, the decision criterion would be the probable effect of each alternative course of action on the company's share of the market; the decision rule would be to select the alternative which will contribute the most to capturing the maximum share. Although share-of-the-market may be a defensible decision criterion in some cases, it is usually inferior to that of profit. If, for example, a company is fighting to gain a foothold in a market where competitors are already well-established, it makes some sense to set some specific percentage of the total market as the primary marketing goal. In the long run, however, it does little good to capture this share, if sales are not made in such ways that long-run company profits tend toward the maximum. When share-of-the-market is established as the main marketing goal, thus resulting in a share-of-the-market decision criterion and rule, management usually is



thinking (or should be) of this as an intermediate check point on the longer road to maximum long-run dollar profit.

***The Profit Decision Criterion and the Operating Statement***

Because long-run dollar profit is so important as a decision criterion, it is essential that today's marketing manager be familiar with the nature of the relationships of profit to other items on the company operating statement—also called profit and loss statement. Our purpose in this section is to show how the operating statement can be used in analyzing marketing problems and in making decisions on them.

The operating statement of any firm (retail, wholesale, or manufacturing) is based on two basic accounting formulas:

1. Sales — Cost of Goods Sold = Gross Margin (or Gross Profit)
2. Gross Margin — Expenses = Net Profit

With the numbers filled in, combined, and arranged in conventional accounting style, the operating statement (in skeleton form) might appear as follows:

Sales .....	\$1,000,000
Less: Cost of Goods Sold.....	650,000
Equals: Gross Margin (Gross Profit) .. .	\$ 350,000
Less: Expenses .....	250,000
Equals: Net Profits .....	\$ 100,000

Admittedly, this is a highly simplified operating statement, but even in this form it can be a valuable tool for the marketing executive to use in analyzing problems and in making decisions.<sup>6</sup> To illustrate, suppose a marketing manager wants to decide whether to divide his sales force into two parts, each specializing in selling part of the product line. Let us assume that he has decided to use profit as the decision criterion and maximum long-run profit as the decision rule. Assume further that he either has available all the necessary facts and figures, or is able to arrive at usable estimates for those that are missing. Here are some of the items this marketing decision-maker would have to consider:

What will be the effect on sales volume of splitting the sales force on the basis of products?

To what extent will the two groups of salesmen be calling on different or the same lists of customers and prospects? What effect will this have on total sales? On total expenses?

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<sup>6</sup> Later, in Chapter 12, more detailed operating statements are explained and discussed with regard to their use in marketing decision-making.

Will the change in sales volume affect costs of goods sold? How?

If expenses are increased by the change, will there be a more than offsetting increase in gross margin? If so, how much?

What will be the effects on sales volume, cost of goods sold, gross margin, and expenses if the sales force is not split as proposed?

Are there other alternatives besides those proposed? (For the sake of keeping this illustration simple, assume there are not.)

As a starter, the marketing manager would want to obtain figures on the present breakdown of last year's operating statement according to the two groups of products. Let's assume he asks the accounting department for this breakdown and receives the following:

Operating Results—Last Year			
	<i>Product Group I</i>	<i>Product Group II</i>	<i>Total</i>
Sales	\$600,000	\$400,000	\$1,000,000
Cost of Goods Sold	350,000	300,000	650,000
Gross Margin	\$250,000	\$100,000	\$ 350,000
Expenses *	180,000	70,000	250,000
Net Profits	\$ 70,000	\$ 30,000	\$ 100,000

\* Since many expenses, such as the sales manager's salary, are shared by both product groups, they can only be apportioned to the product groups on a somewhat arbitrary basis. If, as in this case, an allocation is needed to facilitate analysis, the best available basis of allocation, such as apportioning total expenses according to the relative number of order lines (i.e., lines on customers' order sheets) accounted for by orders for products in each group, should be selected. In the hypothetical company considered here, we are assuming that accounting records were kept in such a manner that sales, cost of goods sold, and hence gross margin figures could all be readily broken down according to product groups. In many real-life companies, the record-keeping is such that a breakdown of this kind could be made only after a great deal of resifting and rearranging of original accounting records. But enlightened marketing managers today are insisting that accounting records be so organized that they lend themselves readily to the analysis of marketing problems. A whole branch of subject matter—distribution cost accounting and analysis—has developed to expedite analyses of this sort.

Having received the operating statement in the form requested, the marketing manager proceeds to use it as a source of information for making his predictions of the consequences of each of the two alternatives. Regardless of the alternative finally decided upon, it will be in effect for an indefinite period in the future. So the marketing manager goes ahead and makes his predictions, or projections, in terms of average annual operating results.<sup>7</sup> He makes separate projections of operating re-

<sup>7</sup> Because we want to keep this example as simple as possible, we are using projections of average annual operating results. This is appropriate procedure whenever management is unable or unwilling to state a specific number of years during which the decision is to be in effect. Whenever management is able to state a finite period over which the decision is to be in effect, projections are made for each of a number of successive operating periods which are then totaled to provide a statement of the long-run operating results.

sults under each of the two alternatives: continued use of a single sales force, and use of two "product group" sales forces. These two *pro forma* (i.e., "projected") statements appear below:

**Alternative 1: Continuation of Single Sales Force—  
Projection of Average Annual Operating Results**

	<i>Product Group I</i>	<i>Product Group II</i>	<i>Total</i>
Sales	\$650,000	\$420,000	\$1,070,000
Cost of Goods Sold	375,000	315,000	690,000
Gross Margin	\$275,000	\$105,000	\$ 380,000
Expenses	200,000	75,000	275,000
Net Profit	\$ 75,000	\$ 30,000	\$ 105,000

**Alternative 2: Two "Product Group" Sales Forces—  
Projection of Average Annual Operating Results**

	<i>Product Group I</i>	<i>Product Group II</i>	<i>Total</i>
Sales	\$750,000	\$600,000	\$1,350,000
Cost of Goods Sold	410,000	440,000	850,000
Gross Margin	\$340,000	\$160,000	\$ 500,000
Expenses	280,000	90,000	370,000
Net Profit	\$ 60,000	\$ 70,000	\$ 130,000

By working through the several estimates needed to complete the two *pro forma* operating statements, the marketing manager forces himself to consider all the factors bearing on the decision which conceivably might affect net profit. After analyzing demand and competitive factors, he concludes that no change in prices will be needed. His investigation also shows that there will be some variation in the percentage relationship of cost of goods sold to sales volume, but no important variations. But he finds that significant variations are likely to occur in expenses. By organizing his analysis this way, he has had to quantify his estimates of each of these factors under both alternatives and this has served to check any tendency toward loose thinking.

Comparing these projections with last year's operating results, the marketing manager now has some basis for thinking that, regardless of the alternative selected, total sales and net profits are likely to be higher than they have been. Under Alternative 2, as might be expected, concentrated effort by specialized salesmen should result not only in higher total sales, but in higher sales of each Product group, especially of Product Group II. In this particular case, the percentage relationship of cost-of-

goods-sold to sales for both product groups under both alternatives does not vary significantly; although, with higher sales volumes, there is a slight percentage decline in this relationship. The greatest variation is in the expenses category: for Product Group I, under Alternative 1, increasing sales from \$600,000 to \$650,000, a bit more than 8 per cent, causes expenses to rise by about 11 per cent; but, under Alternative 2, adding 25 per cent to sales, from \$600,000 to \$750,000, requires more than a 60 per cent rise in expenses. In the case of Product Group I, the net effect of this change in the expenses-to-sales relationship is to increase net profit at the \$650,000 sales level and to decrease net profit at the \$750,000 level. Contrast this with what happens to Product Group II—increased expenses and cost-of-goods-sold effectively cancel out any profit gain when sales rise from \$400,000 to \$420,000; but, as sales increase to the \$600,000 level, expenses increase less than proportionately and net profit more than doubles.

Since maximum long-run net profit was the decision rule, the marketing manager decided on Alternative 2. Having decided in favor of this alternative, one of the marketing manager's next moves might well be to consider what might be done to reduce the expenses for Product Group I. From the estimates in the *pro forma* statements, it appears offhand that these expenses could be reduced and net profit increased if sales were kept below the \$750,000 level. This might or might not be the case, but the matter at least merits further investigation by management. Our example, thus, has uncovered another benefit which results from using the profit decision criterion—other important situations affecting net profit are called to management's attention.

#### *Incremental Analysis and Decision-Making*

Incremental analysis, i.e., comparing alternatives by the *changes* they effect in operating data rather than by their total impact on operating results, usually helps to bring differences among alternative solutions into clearer focus. Remember that, in the previous illustration, the estimates showed that changes in expenses would account for most of the variation in net profit. The analysis could have been sharpened had the marketing manager considered only *incremental changes*. After all, the only sales dollars relevant to the decision are those that vary with it, and the only part of cost-of-goods-sold bearing on the decision is the part which changes with sales volume. Similar reasoning holds with regard to expenses—only the incremental changes in expense are pertinent to the decision. After determining incremental changes in sales, cost, of goods sold, and expenses, the incremental gross margin and incremental net profit can be calculated. Using the data from our earlier illustration

and calculating the incremental figures for each of the two alternatives, the incremental projections are as shown below:

Incremental Change in	Projections of Average Annual Incremental Changes in Operating Statement					
	Under Alternative 1			Under Alternative 2		
	Product Group I	Product Group II	Total	Product Group I	Product Group II	Total
Sales	+\$50,000	+\$20,000	+\$70,000	+\$150,000	+\$200,000	+\$350,000
Cost of Goods Sold	+ 25,000	+ 15,000	+ 40,000	+ 60,000	+ 140,000	+ 200,000
Gross Margin	+ 25,000	+ 5,000	+ 30,000	+ 90,000	+ 60,000	+ 150,000
Expenses	+ 20,000	+ 5,000	+ 25,000	+ 100,000	+ 20,000	+ 120,000
Net Profit	+ 5,000	—0—	+ 5,000	— 10,000	+ 40,000	+ 30,000

Thus, we have introduced the concept of *incremental net profit*. This is defined as the change (increase) in average annual net profit resulting from the implementation of a managerial decision with respect to any one of a number of possible aspects of a firm's operations.<sup>8</sup> Incremental net profit, in other words, is the difference between the projected net profit and the previous net profit. Incremental net profit under Alternative 1 in the illustration is \$5,000, while under Alternative 2 it is \$30,000. This means that adopting Alternative 2 should mean \$25,000 more added to net profit than if Alternative 1 were adopted. Notice, however, that the incremental net profit in Alternative 2 accrues entirely from Product Group II and that Product Group I actually shows an incremental net loss. This incremental net loss results from the fact that the \$90,000 incremental gross margin for Product Group I under Alternative 2 is lower than the \$100,000 in incremental expenses. If Alternative 2 is adopted, therefore, the marketing manager should look into the possibilities of reducing expenses for Product Group I.

When using incremental analysis to decide among alternative courses of action, an executive needs an appropriate decision criterion and rule. We stated previously that long-run dollar profit should be the main decision criterion and maximum long-term dollar profit the main decision

<sup>8</sup> These aspects may include, among others, such matters as diversification into different product lines, differentiation of existing products, changing distribution channels or the intensity of distribution, increasing sales effort through salesmen or advertising or both, and the improvement of warehousing and shipping efficiency. See: M. H. Spencer and L. Siegelman, *Managerial Economics* (Homewood, Ill.: Richard D. Irwin, 1959), pp. 123-124.

rule. If we are to use incremental analysis, however, this criterion and rule require modification. The decision criterion becomes incremental long-run dollar profit, and the decision rule is to select that alternative resulting in the largest incremental long-run dollar profit. These modifications are necessary because incremental analysis involves considering only those figures which are relevant to the decision. In practical decision-making, this decision criterion and decision rule often undergo further change and become "average annual" instead of "long-run" incremental dollar net profits.

Whether a decision-maker uses average annual incremental profit or long-run incremental profit as his decision criterion and rule, he still has the problem of determining how long a period of time to use as a basis for making the calculations. In decision theory, this period is called the "payoff" period. Generally, the payoff period should be long enough to capitalize fully on the opportunities, and short enough to avoid undue amounts of risk. This may be a valid generalization, but it isn't a great deal of help to the decision-maker. Somewhat more helpful is the fact that a reciprocal relationship exists between the length of the payoff period and the rate of return on investment desired by management. For instance, and greatly simplifying, if management wants to recover at least 10 per cent of the funds invested in a program each year, the maximum length of the payoff period would be  $100 \text{ per cent} \div 10 \text{ per cent} = 10 \text{ years}$ .<sup>9</sup> In other words, management would want its investment returned within ten years. There would, of course, be no profit if something in addition to the investment were not returned during that time. Thus, in our example, if the investment is to return a profit, it is necessary for the life of the investment to be longer than the payoff period, i.e., it has to be longer than ten years. Even though calculating the length of the payoff period and the life of the investment may seem confusing and unduly complicated, a marketing decision-maker cannot afford to neglect this task. Only if he makes these calculations, is it possible for him to think fully in terms of the "average annual" or the "long-run" net profit, whether incremental or not.

#### *Handling Uncertainties in Marketing Decision-Making*

Evaluation or comparison of decision alternatives, whether according to the incremental dollar net profit criterion or other criteria, requires the

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<sup>9</sup> Actually, in the economist's language, we would have to *capitalize* the expected incremental profit at some desired rate of return on investment. The inward flow of profit, which appears over many periods projected in the future, would have to be separated and converted into dollars of the same time period via the capitalization rate. Many complications are encountered in making these calculations. For a good discussion of these complications and suggestions for making the needed computations, see: Spencer and Siegelman, *op. cit.*, pp. 120-124, 381-396.

quantification of future operating experience. This means that the decision-maker needs estimates for such basic factors as selling prices, unit sales volumes, cost of goods sold per unit of product, and expenses per unit of product sold. When any sort of profit criterion is used, these factors are set into three equations:

1. Selling Price per unit	×	Sales Volume in units	=	Sales Volume in dollars
2. Cost of Goods Sold per unit	×	Sales Volume in units	=	Cost of Goods Sold in dollars
3. Expenses per unit	×	Sales Volume in units	=	Expenses in dollars

Notice that we have to use these three equations in order to get the figures needed for completing the two basic accounting equations, which we used in our earlier example. These accounting equations are:

4. Sales Volume — Cost of Goods Sold = Gross Margin
5. Gross Margin — Expenses = Net Profit

For each alternative course of action being evaluated, therefore, the decision maker needs a set of four estimates—estimates for selling price per unit, cost of goods sold per unit, expenses per unit, and sales volume in units. These estimates are predictions, and predictions, especially in the marketing area, are hazardous. Regardless of the excellence of the forecasting techniques and procedures and the competence of the forecaster, there is always some chance that these forecasts will be in error. Competitors' actions, for instance, may upset the most careful forecast of future operating results, even though an attempt has been made to anticipate their actions in making the forecast. Moreover, changes in a multitude of complex economic, psychological, social, and legal forces (the "uncontrollables"), are always exerting influences on a company's cost and expense structure and on its sales situation; these changes may upset the most carefully prepared forecasts. Thus, the marketing decision-maker definitely needs some way to handle these uncertainties.

The main technique used by marketing decision-makers in dealing with uncertainties involves the use of probability distributions. Put briefly, a probability distribution gives the "odds" for and against the occurrence of a certain outcome: i.e., it shows the proportion of the time that one can expect a certain outcome. Assume, for example, that a marketing manager asks his marketing research department to prepare a *probability forecast* of the average annual sales for a new product which the company is planning to introduce. He instructs the marketing researchers

to consider two different selling prices in making the forecasts—\$1.15 per unit and \$1.25 per unit. Notice that the marketing manager in this illustration made his own estimates of selling price. Because this decision concerns the selling price to be placed on a new product, the decision is to be made from among different selling prices, the decision alternatives.

Also notice that the decision criterion here cannot be incremental net profit inasmuch as the company does not have any operating experience with the new product. Because of this, the marketing manager will use the *contribution to net profit* decision criterion, which is defined as total gross margin less total variable expenses. These variable expenses are of the "out-of-pocket" type that will be incurred when the new product is added and include such items as advertising expenses for the new product and salaries of special salesmen hired to promote it. The marketing manager feels in this instance, and rightly so, that fixed expenses—those which would still have to be met even if the new product were never marketed—can safely be disregarded. Such fixed expenses include, among others, rent, property taxes, and executive salaries. Because contribution to net profit is the decision criterion here, the marketing manager plans to evaluate the two alternative prices according to the total number of dollars each will contribute to net profit.

In due time, the requested forecasts come to the marketing manager in the following form:

If unit selling price is \$1.15	The probability is	That sales will be
	5%	0—50,000 units
	80	50,000—100,000
	15	100,000—150,000
If unit selling price is \$1.25	The probability is	That sales will be
	30%	0—50,000 units
	65	50,000—100,000
	5	100,000—150,000

In other words, if unit selling price is set at \$1.15, there are 80 chances out of 100 that sales volume will be between 50,000 and 100,000 units. Notice, however, that there are 20 chances out of 100 that sales will be either above or below that range. Similarly, if unit selling price is set at \$1.25, there are 65 chances out of 100 that sales volume will be in the 50,000—100,000 range and 35 chances out of 100 that it will not. Thus,



the risk of having sales fall outside this particular range is greater with the \$1.25 price than with the \$1.15.

Before he can evaluate the two selling prices according to the contribution to net profit criterion, the marketing manager needs some more estimates. He needs estimates for the cost of goods sold per unit and for variable expenses per unit at various levels of sales volume. So he asks the controller to provide these estimates for sales volumes of 25,000 units, 75,000 units, and 125,000 units. Notice that these volumes are the mid-points for each of the ranges of sales volume ranges for which the marketing manager has received probability forecasts. In order to simplify this illustration, let us assume that the controller is able to provide these estimates with absolute certainty.<sup>10</sup> He estimates that variable expenses per unit will amount to 20¢ at all three sales volume levels. He further estimates that cost of goods sold per unit will amount to 70¢ at a volume of 25,000, 60¢ at 75,000, and 50¢ at 125,000.

With the data received from the marketing researchers and the controller, the marketing manager is ready to go on with his calculations. His first step is to compute the contributions to profit for each selling price at each of the possible sales levels. These calculations are shown below:

(Units × Price) – (Units × Unit Cost of Goods Sold) – (Units × Unit Variable Expenses) = Contribution to Profit before Uncertainty Taken into Account

$$\begin{aligned} (25,000 \times \$1.15) - (25,000 \times \$0.70) - (25,000 \times \$0.20) &= \$ 6,250 \\ (75,000 \times 1.15) - (75,000 \times 0.70) - (75,000 \times 0.20) &= 26,250 \\ (125,000 \times 1.15) - (125,000 \times 0.70) - (125,000 \times 0.20) &= 56,250 \\ \\ (25,000 \times \$1.25) - (25,000 \times \$0.70) - (25,000 \times \$0.20) &= \$ 8,750 \\ (75,000 \times 1.25) - (75,000 \times 0.70) - (75,000 \times 0.20) &= 33,750 \\ (125,000 \times 1.25) - (125,000 \times 0.70) - (125,000 \times 0.20) &= 68,750 \end{aligned}$$

The marketing manager's next step is to take the uncertainties as to sales volume into account. He has gotten probability figures on these uncertainties from marketing research, and it is time now to work them into the calculations. For this purpose, it is convenient to use a decision matrix (see Figure 11.1). On the first and fourth lines of this matrix, the marketing manager writes in the probability percentages representing the chances of each sales level occurring at each of the two proposed prices. On the second and fifth lines, he inserts the figures for estimated contribution to profit. Then, he multiplies each contribution to profit

<sup>10</sup> Had the controller not been able to furnish these estimates with absolute certainty, he would provide sets of estimates together with a statement of the probability of each estimate occurring. The technique for handling probability estimates of unit costs and expenses is essentially the same as that used with probability forecasts of sales volume.

figure on line two by the probability percentage directly above it on line one; and he repeats this process for the figures on line five and the percentages on line four. The resulting computations are inserted on lines three and six respectively. Next, the marketing manager adds lines three and six horizontally and puts these totals in the boxes on the right-hand side of the matrix. The decision criterion is contribution to net profit, and the decision rule, in our example, is to select the selling price with the highest *expected* contribution to net profit. Comparing the

**Figure 11.1**  
Decision Matrix—Contribution to  
Profit Incorporating Probabilities

<i>Forecasted Sales</i>	<i>25,000 (0—50,000)</i>	<i>75,000 (50,000— 100,000)</i>	<i>125,000 (100,000— 150,000)</i>	<i>Expectation</i>
1. Probability of Sales Level if \$1.15 price used	.05	.80	.15	
2. Contribution to Profit at \$1.15 price	\$6,250	\$26,250	\$56,250	
3. 1. × 2.	\$312.50	\$21,000	\$8,437.50	\$29,750
4. Probability of Sales Level if \$1.25 price used	.30	.65	.05	
5. Contribution to Profit at \$1.25 price	\$8,750	\$33,750	\$68,750	
6. 4. × 5.	\$2,625	\$21,937.50	\$3,437.50	\$28,000

totals in the two boxes, it is clear that the expectation for the highest contribution to net profit is greater at the \$1.15 price than at the \$1.25 price. Thus, the decision is to use the \$1.15 price.

This approach to decision-making, with appropriate modifications made according to the type of problem under study, can be used for a wide variety of marketing decisions. The chief requirements for using it are that: (1) the required numerical data are or can be made available, and (2) given outcomes can be expressed in terms of the probabilities of their occurrence. The form, or design, of the decision matrix, of course, can readily be altered in any way which facilitates the making of computations and comparisons.

This illustration, though long and seemingly involved, is actually a highly simplified one and, to keep it simple, we have made a number of

assumptions. Even though we have simplified this illustration greatly, the important thing for the student to grasp is the general nature of this approach to marketing decision-making. This approach provides a technique for taking uncertainties into account in decision-making and it is extremely versatile—it can be modified and adapted in many ingenious ways so as to facilitate the analysis and deciding of many classes of marketing problems. The decision-maker, however, should avoid using this approach rigidly—it is not a rigid mold but a flexible pattern requiring modifications appropriate to the particular decision being made and to the decision criterion and rule being used.

### **CONCLUSION**

Marketing men must have management and decision-making skills—analysis and discussion in this chapter have focused on these types of skills. Competent managers must be well-grounded in the practice of management. In marketing, this means that executives must know how to apply planning, organizing, coordinating, and controlling skills to the management of marketing activities. It means, too, that they need to be skilled in making decisions and in carrying through the analyses leading up to decisions. Many of the decisions marketing executives make are intuitive in nature. Others, especially highly important ones made rather infrequently, require more formal and logical approaches to decision-making. Some of these approaches have been illustrated in this chapter. But in making either intuitive or rational decisions, there is little doubt that the modern marketing manager needs considerable ingenuity, uncommon imagination, and a great deal of common sense.

### **QUESTIONS AND PROBLEMS**

1. What does management *manage*? What does marketing management manage? What functions are performed by managers? By marketing managers? How does the job of the marketing executive differ from the jobs of other executives?
2. "It is the first duty of a business to survive," writes Peter Drucker in *The Practice of Management* (New York: Harper & Bros., 1954), p. 46. Explain how this statement of Peter Drucker is consistent with the main marketing (and company) goals as discussed in this chapter.
3. "Even without management, there would still be marketing." If this statement is substantially true, how can management's role in marketing be justified?

4. Explain the meaning of the following terms:
 

a. planning	f. uncontrollable
b. organizing	g. economic man
c. coordinating	h. weak ordering
d. controlling	i. decision
e. controllable	j. decision-making
5. "Marketing management's basic problem is to adjust the forces under its control within an environment composed of diverse and ever-changing forces outside its control." List the major marketing controllables and uncontrollables and construct a diagram to illustrate the basic problem of marketing management.
6. Show how the three main marketing goals (sales volume, net profits, and growth) are related and interdependent.
7. "The establishment and definition of marketing goals are necessary prerequisites to marketing decision-making." Discuss.
8. Compare intuitive decision-making and rational decision-making. Under what sets of circumstances should marketing managers make intuitive decisions? Rational decisions?
9. Contrast the decision-making procedure of economic man with the four steps in the logical analysis of a business problem (as given in this chapter).
10. Discuss the relationship of information, problem conceptualization, and prediction in marketing decision-making.
11. Appraise the importance of a company's system of controls from the standpoint of the marketing decision-maker.
12. Explain how marketing decision-makers might use probability distributions in dealing with uncertainties.
13. What marketing goals, decision criteria, and decision rules might be appropriate in each of the following situations? Explain your reasoning in each instance.
  - a. Company A is planning to introduce its product in a market area where local competitors are very strong.
  - b. Company B has operated its plant at only 50 per cent of capacity for several years. Consequently, unit manufacturing costs are higher than the industry average. If Company B could utilize the full capacity of its plant, unit manufacturing costs would be comparable to those of B's chief competitors.
  - c. For a long period of years, Company C's product has been the largest seller in the industry. Recently, one of

C's main competitors has been making a strong bid for industry leadership and, in the process, has been cutting prices.

- d. Company D's main product has experienced declining sales for a number of years, due mainly to the introduction of substitutes by companies in competing industries.
14. Explain how the contribution-to-net-profit decision criterion differs from the incremental-net-profit decision criterion. In what sets of circumstances might it be appropriate to use each of these criteria?
  15. The marketing manager of the Rogers-Dunn Company, a men's hosiery manufacturer, is considering the advisability of changing his firm's pricing and promotional policies. Currently, 1,000,000 pairs are sold annually to retailers at a price of \$1.20 per pair, and total promotional expenditures amount to \$100,000. At the current rate of production, cost of goods sold per unit (i.e., per pair of hosiery) is 60¢. The marketing manager has outlined various possible alternatives, secured necessary estimates for each, and has summarized them as follows:
    - a. If the price to retailers is left at \$1.20 per pair and total promotional expenditures remain at \$100,000, the sales forecast for next year is 1,200,000 pairs. At that sales rate, unit cost of goods sold will be 55¢.
    - b. If the price to retailers is reduced to 90¢ per pair and total promotional expenditures remain at \$100,000, the sales forecast for next year is 1,500,000 pairs, and unit cost of goods sold will be 50¢.
    - c. If the price to retailers is left at \$1.20 per pair and total promotional expenditures are increased to \$200,000, the sales forecast for next year is 1,300,000 pairs and cost of goods sold per unit will be 54¢.
    - d. If the price to retailers is reduced to 90¢ per pair and total promotional expenditures are increased to \$200,000, the sales forecast for next year is 1,700,000 pairs and cost of goods sold per unit will be 45¢.

Assuming that the marketing manager has ruled out all other alternatives but these four, which alternative should he select, and why?

16. The marketing manager of Conant Products Company is faced with the problem of deciding which of two prices should be placed on a new product. The two prices under considera-

tion are \$10 and \$12. The marketing research department has prepared probability forecasts of average annual sales of the new product for each of the two prices as follows:

If unit selling price is \$10	The probability is	That sales will be
	10%	0— 5,000 units
	40	5,000—10,000
	40	10,000—15,000
	10	15,000—20,000
If unit selling price is \$12	The probability is	That sales will be
	15%	0— 5,000 units
	55	5,000—10,000
	25	10,000—15,000
	5	15,000—20,000

The controller has estimated cost of goods sold per unit at \$6 at a volume of 2,500, \$5 at 7,500, \$4.50 at 12,500 and \$4 at 17,500. The controller states that variable expenses per unit will amount to \$2 per unit at all four sales volume levels.

What price should be placed on the new product, and why?

O P E R A T I N G

D A T A

F O R

M A R K E T I N G

D E C I S I O N S

# 12

Information is needed both to begin and to carry through the analysis of any marketing problem. We need information in order to understand the nature of the problem (i.e., for conceptualizing it) and to predict the consequences of alternative ways of dealing with it. This chapter and the two that follow are designed to acquaint you with some of the more important sources and uses of information for marketing decision-making and to explain the principal analytical methods used by executives in working with such data.

### **SCHEMES FOR CLASSIFYING MARKETING INFORMATION**

There are three main schemes for classifying information useful for marketing decision-making: (1) according to sources, (2) according to uses, and (3) according to whether it is qualitative or quantitative information. Before beginning our analysis of operating data, let us consider briefly each of these classification schemes. This should provide us with a better background against which to appraise the significance of the later discussion.

#### *Classification by Sources*

Marketing information may be classified as either internal or external. Internal information is made up mostly of data contained in or capable of being compiled or extracted from available company records. Examples of such internal sources include the firm's operating statement, sales records, and production records. External information consists of data gleaned either from reports of governmental agencies, trade associations, and other "outside" organizations, or obtained from marketing research studies. In this chapter, we focus directly on internal data. In the next chapter, "Marketing Research," we will concentrate on external data.

#### *Classification by Uses*

Most uses of marketing information, of course, fall under the general heading of "decision-making," but executives also use such information for planning and control purposes. All three of these uses typically require information from both internal and external sources. For example, an executive attempting to make a pricing decision needs such internal data as that on production and marketing costs, and such external data as that concerning the strength of probable consumer demand at different prices. Similarly, when an executive is drafting plans preliminary to the market introduction of a new product, he needs such internal data as production costs at different levels of production and estimated storage costs, and such external data as the number of consumers who may buy the product and the likely intervals between first and repeat purchases by different classes of consumers. Similarly, an executive taps both internal and external sources when he wants information for purposes of control. For example, in evaluating a salesman's performance, an executive would probably want to consider the individual's sales record (internal) and the territorial sales potential (obtained from external sources). In this chapter, as we said earlier, we concentrate on data gathered from internal sources. We will illustrate how such internal data is put to use in making marketing decisions, some of which have planning



and controlling implications. The fact that putting information to use in decision-making typically requires the tapping of external as well as internal sources will become increasingly apparent as our discussion progresses.

#### ***Qualitative and Quantitative Information***

Qualitative information is factual information expressed in general terms. An example would be information on whether a competitor plans to come out with a given type of new product. Quantitative information, in contrast, is expressed in numerical terms as, for example, the fact that the potential trading area of a proposed new supermarket contains 13,500 families with a median family income of \$7,500 per year. Both qualitative and quantitative items of information are required for making marketing decisions. Many items of qualitative information are relatively easy to obtain simply through reading business magazines and trade journals, casual conversations with other executives and through personal observation. For example, a marketing executive might first learn that a competitor has launched a new product through reading about it in the trade press, or from a chance remark made by his seat companion on the Chicago-to-New York flight or from actually seeing the new competitive item on sale in a local supermarket. Other items of qualitative information, however, are relatively difficult to come by—for example, reliable and valid information on what motivates consumers to buy specific products and brands. Except in a comparatively few cases, as where published government and trade association statistical reports are available, quantitative items of information are generally much more difficult to obtain than most qualitative items of information. In most cases, quantitative data must be collected from internal and external sources and rearranged into forms which will facilitate the analysis leading up to decision-making. In this chapter we are mainly concerned with quantitative items of information and the rearranging of such items into forms which facilitate decision-making. Nevertheless, the fact that qualitative items of information can and do significantly affect marketing decision-making will also be evident.

#### **THE OPERATING STATEMENT AND OPERATING RATIOS**

The operating statement, or profit-and-loss statement as some companies call it, is the most widely-used internal source of marketing information. Marketing executives should be well-versed in the accounting concepts which are used in preparing the operating statement, and they must know how to use this statement as a tool in the making of marketing decisions. The operating statement, by definition, is a financial summary of operating results for some given period, usually a month

or a year. It shows whether the firm operated at a profit or a loss, and explains how that profit or loss resulted from the quantitative relationships which existed between sales and cost of goods sold and expenses. By "cost of goods sold," we mean the total cost value of the goods actually sold during the period and not the value of the goods on hand at any particular time. By "expenses," we mean the marketing, general, and administrative costs incurred by the business during the operating period. If the number of dollars of sales income earned during the period exceeded the total dollars obligated for cost of goods sold and expenses, then the operating statement shows a net profit. If the total dollars of sales income were smaller than the total of cost of goods sold and expenses, the operating statement shows a net loss. In the previous chapter, we showed these relationships among the basic components as follows:

	Sales
Minus:	<u>Cost of Goods Sold</u>
Equals:	Gross Margin (or Gross Profit)
Minus:	<u>Expenses</u>
Equals:	Net Profit (or Net Loss)

This skeleton operating statement portrays only the relationships among the major operating items—sales, cost of goods sold, and expenses. Each major item is, in its turn, the result of a set of relationships existing among more detailed items of financial operating data. Exhibit 12.1 below, an operating statement shown in considerable detail, illustrates these several sets of relationships as well as the interrelationships existing among the major operating items.

The "Percentages" column in Exhibit 12.1 expresses the relationships between net sales and several important items in the operating statement. These operating ratios are always expressed as a percentage of net sales with net sales equal to 100 per cent. The rationale for computing all operating ratios with *net sales* as the base, i.e., the denominator or 100 per cent, is that all costs, expenses, and profits (if any) must come out of the proceeds of net sales. Thus, when a businessman says his net profit is 5 per cent, he means that net profits are 5 per cent of net sales. Similarly, when he says that his gross margin is 33 per cent, he means that gross margin is 33 per cent of net sales.

#### **The Gross Margin Ratio**

The gross margin reflects the difference between sales and the cost of the goods that have been sold. Expressing this amount as a ratio of net sales allows comparison with previous operating periods, or with competitors when industry data are available. The gross margin ratio may be increased or decreased in two ways—by changing the selling price

**Exhibit 12.1****Operating Statement for the Year Ending December 31, 196\_\_**

		<i>Percentages</i>	
Gross Sales		\$1,050,000	105.0%
Less: Returns & Allowances		50,000	5.0
Net Sales		<u>\$1,000,000</u>	<u>100.0%</u>
Cost of Goods Sold:			
Opening Inventory @ cost	\$100,000		
Purchases @ Billed Cost	\$650,000		
Less: Purchase Discounts	15,000		
Net Cost of Purchases	<u>\$635,000</u>		
Plus: Freight-In	40,000		
Net Cost of Purchases Delivered		<u>675,000</u>	
Cost of Goods Handled		<u>\$775,000</u>	
Less: Closing Inventory @ Cost		<u>165,000</u>	
Cost of Goods Sold		610,000	61.0
Gross Margin (or Gross Profit)		<u>\$ 390,000</u>	<u>39.0%</u>
Expenses:			
Advertising	\$ 40,000		
Sales Salaries & Commissions	105,000		
Warehousing & Delivery	90,000		
Administrative	40,000		
General & Other	<u>60,000</u>		
Total Expenses		<u>335,000</u>	<u>33.5</u>
Net Profit on Operations (before federal income tax)		<u>\$ 55,000</u>	<u>5.5%</u>

per unit, and by changing the cost per unit. When a marketing executive believes his gross margin ratio is high or low in relation to his own past performance or the experience of his competitors, he may try to change his prices, reduce his costs, or both. Thus, a retailer alerted by an abnormally low gross margin ratio might re-evaluate his buying procedure to find more economical sources of supply, improve his working capital position so as to take advantage of cash discounts, improve his traffic control so as to decrease freight costs, or improve his merchandise selection so as to command higher markups. In the same manner, a manufacturer might be alerted to reduce his production costs or improve his product so as to command a higher markup. Without this analytical tool such inefficiency might go unnoticed.

***The Expense Ratio***

The expense ratio provides the basis for a regular evaluation of the relationship between sales, gross margin, expenses, and profit. It is not concerned with a breakdown analysis of individual expense categories

(discussed later in this chapter) but with a comparison of total expenses and other figures on the operating statement. The ratio of expense to sales may vary considerably between companies, even in the same industry. A company that attracts its customers mainly on the basis of low prices naturally will spend less on selling and will, thus, have a low expense ratio. A company that emphasizes promotion rather than prices as a means of attracting patronage will have a high expense ratio. For this reason, expense comparisons between companies must be made with caution. However, the expense ratio allows management to compare current expenses with those in other operating periods.

#### *Sales Returns and Allowances Ratio*

This ratio, like all other operating ratios, is expressed as a per cent of net sales, even though sales returns and allowances are subtracted from gross sales in order to arrive at the net sales figure. Analysis of sales return and allowance ratios helps management to determine whether these figures represent normal or abnormal experience. A certain number of returns and allowances are expected because of human error and product failings, but excessive returns may reflect bad merchandise or over-selling.

#### *Net Profit Ratio*

This widely-used and well-known operating ratio relates most directly to the profit objective of most businessmen, but used alone it has only limited value. A change in profits may alert management to possible trouble, but since profit results from a combination of sales, gross margin, and expense, an evaluation of all these ratios may be necessary to pinpoint the cause of the change in profits. In the same manner, if management wishes to increase profits, the proposed operational changes should be analyzed in light of the other operating ratios. For example, a retailer might want to estimate the effects on net profit of an anticipated increase in "store traffic." "Supposing," he says, "that increased store traffic causes a 60 per cent rise in sales but requires the hiring of two additional clerks thus raising weekly expenses by \$188." "I would expect," he continues, "that the percentage relationship of cost of goods sold to sales would be unchanged." The weekly operating statement of the retailer's store together with the expected operating statement for the next week based on his assumptions are shown on page 278.

This analysis indicates that the retailer's dollar profits will rise from \$30 to \$40 a week, but the net profit percentage (profit expressed as a per cent of sales) will fall from 3 per cent to 2.5 per cent. It is quite possible, then, for a change in operations to produce more net profit dollars but a smaller net profit percentage. This, of course, does not always hap-

pen, but it does happen often enough for businessmen to be aware of the possibility. Marketing men nearly all agree that the dollar payoff is the most important item to consider, but they also agree that the percentage relationships are helpful in making contrasts and comparisons.

	<i>Present Situation</i>		<i>Contemplated Situation</i>	
	\$	%	\$	%
Sales	\$1,000	100%	\$1,600	100%
Cost of Goods Sold	670	67	1,072	67
Gross Margin	\$ 330	33%	\$ 528	33%
Expenses	300	30	488	30.5
Net Profit	\$ 30	3%	\$ 40	2.5%

#### **OTHER ANALYTICAL RATIOS AND THEIR USES IN DECISION-MAKING**

Several analytical ratios serve as everyday aids which marketing executives use in their decision-making. Included among these ratios are the markup, the markdown, and the rate of stockturn. These ratios are so well-known, in such wide usage, and so basic to marketing decision-making, that they constitute the main subject matter of "marketing arithmetic." Although only simple calculations are required, you should make every effort to understand fully the ideas and terminology involved. One preliminary word of caution is in order: The following discussion often uses retailing-type situations to illustrate the analytical ratios and their uses. Wholesalers also use these ratios, but the methods of calculation are identical and there is no need for "duplicate" illustrations. These particular ratios do not apply directly to the operations of manufacturing firms but apply instead to the operations of middlemen handling the products of manufacturers. Thus, marketing executives in manufacturing firms cannot afford to ignore these ratios. Such marketing executives not only should know how middlemen use these ratios, but should use them themselves in planning their own marketing and promotional programs. Marketing executives at all distribution levels need to know and understand the fundamentals of marketing arithmetic presented on the next few pages.

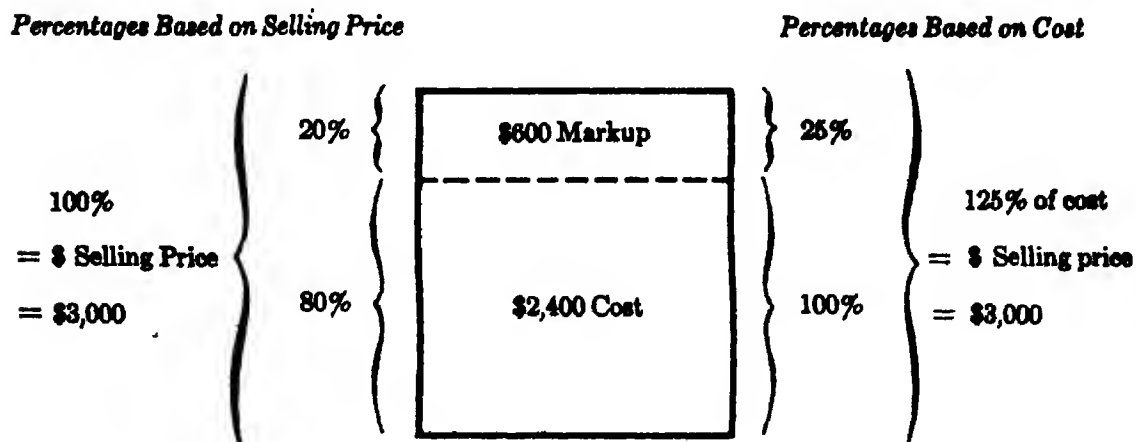
#### *Markup*

The amount by which an item's selling price exceeds its cost to the seller is known as the markup. When, for example, a discount house pays \$15 for a transistor radio and prices it at \$20, the \$5 difference is the markup. Out of the total of all such markups placed on all of the items it sells,

the discount house seeks to cover its expenses and earn a net profit. Notice that so far we have discussed markup only in terms of dollars.

A businessman not only thinks of a markup in terms of so many dollars and cents but also as some percentage either of *original selling price* or of *cost*. He often uses the markup concept, in other words, as an analytical ratio to express the relation between dollar markup and original dollar selling price or dollar cost. If an automobile dealer pays the manufacturer \$2,400 for a vehicle and prices it at \$3,000, his markup percentage is 20 per cent (i.e.,  $\frac{\$600}{\$3,000}$ ) on the selling price and 25 per cent (i.e.,  $\frac{\$600}{\$2,400}$ ) on the cost. Most sellers use original selling price rather than cost as the base, and whenever we speak of markup as a percentage, we will mean markup as a percentage of original selling price. Keep in mind, however, that under either system of computing markup percentages, you are dealing with the same dollar markup. In one system you relate it to dollar selling price, in the other you relate it to cost. In order to clarify the relationship between these two markup systems, consider Figure 12.1 below, which illustrates the situation mentioned earlier where the auto dealer priced a vehicle at \$3,000.

Figure 12.1



Laymen often get confused when a retailer says, for example, that he decides on the selling price of an item by marking it up by some per cent of the selling price. When asked how he can apply a percentage markup to a selling price which he doesn't even know yet, but which he is trying to determine, the retailer answers: "Very simple. All I do is divide the dollar cost by the cost percentage." What the retailer is trying to explain can be shown more clearly if we refer to the diagram above. The auto dealer knows the dollar cost (\$2,400) and if his desired markup

percentage on the selling price is 20 per cent, he can simply subtract this from the selling price percentage (100 per cent) to determine the cost percentage of 80 per cent. Then, dividing the \$2,400 dollar cost by the 80 per cent *expressed as a decimal*, he arrives at the selling price of \$3,000. Or, shown in the form of an equation, this is what the dealer does:

$$\frac{\$2,400 \text{ (Dollar Cost)}}{.80 \text{ (Cost \% expressed as a decimal)}} = \$3,000 \text{ (Selling Price)}$$

Notice, too, that if the dealer knew how many dollars of markup he desired, and also the markup percentage he wanted, he could calculate not only the selling price but also how much he could pay the manufacturer and still realize the desired dollar and percentage markups. The relevant calculations are:

$$\frac{\$600 \text{ (Dollar Markup)}}{.20 \text{ (Markup \% expressed as a decimal)}} = \$3,000 \text{ (Selling Price)}$$

$$\$3,000 \text{ (Selling Price)} - \$600 \text{ (Dollar Markup)} = \$2,400 \text{ (Cost)}$$

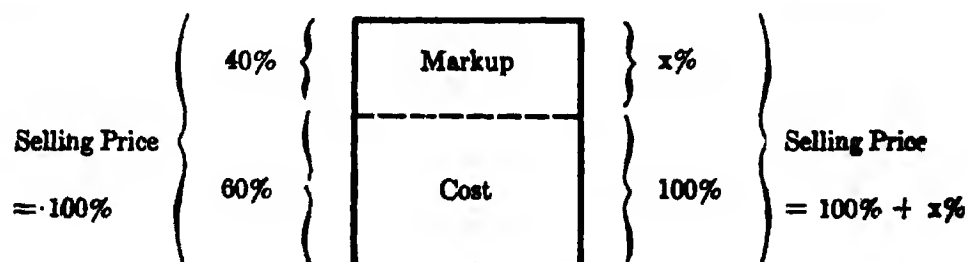
$$\text{Selling Price (100\%)} - \text{Markup (20\%)} = \text{Cost (80\%)}$$

It is often necessary to convert a markup percentage from one base to the other. One way to make such a conversion is to draw a diagram (similar to those we have been using), insert the percentages you know, and find the percentage you are looking for through a few simple algebraic calculations. Assume, for example, that you are using a 40 per cent markup on the selling price and want to find the equivalent markup percentage based on cost. You start by drawing the following diagram:

**Figure 12.2**

*Percentages Based on Selling Price*

*Percentages Based on Cost*



You have no difficulty in writing in the known percentages based on selling price: 40 per cent markup, 60 per cent cost, and 100 per cent selling price. You also know that under the cost percentage markup system, cost equals 100 per cent, so you insert that figure. You now label the markup percentage based on cost as x per cent and the resulting selling

price as 100 per cent + x per cent and assemble the pertinent known and unknown percentages into an equation:

$$\frac{40}{100} = \frac{x}{100 + x}$$

Now, cross-multiply and solve for x:

$$\begin{aligned} 4,000 + 40x &= 100x \\ 4,000 &= 60x \\ x &= 66\frac{2}{3}\% = \text{Markup \% on Cost} \end{aligned}$$

If you knew the markup per cent on cost was 66 $\frac{2}{3}$  per cent and wanted to determine the equivalent markup per cent on selling price, then, of course, markup per cent on the selling price would be labeled x% on the diagram. This results in the following equation and solution:

$$\begin{aligned} \frac{x}{100 - x} &= \frac{66\frac{2}{3}}{100} \\ 100x &= 6666\frac{2}{3} - 66\frac{2}{3}x \\ 166\frac{2}{3}x &= 6666\frac{2}{3} \\ x &= \frac{6666\frac{2}{3}}{166\frac{2}{3}} = 40\% = \text{Markup \% on Selling Price} \end{aligned}$$

Both types of conversion calculations, therefore, can be expressed as formulas:

$$\text{Markup \% on Cost} = \frac{\text{Markup \% on Selling Price}}{100\% - \text{Markup \% on Selling Price}}$$

$$\text{Markup \% on Selling Price} = \frac{\text{Markup \% on Cost}}{100\% + \text{Markup \% on Cost}}$$

If you remember that the markup per cent on cost is always larger than the equivalent markup per cent on selling price, you should have little difficulty in remembering which formula has the “-” and which has the “+.”

### *Markdown*

Merchandise does not always sell at the original selling price placed on it, and a seller may, in an effort to “make it move,” mark down, or reduce, the price. When a gift shop proprietor, for example, concludes that a fancy ashtray is not going to sell at the \$10 price he put on it in the beginning, he may mark it down to \$7.50 at which price a customer finally buys it. The difference between the original selling price and the actual selling price is called the markdown. The dollar markdown, then, is \$2.50 in the ashtray example. Retailers customarily compute mark-



down percentages using actual selling price rather than original selling price as the base. So when an item is marked down from \$10 to \$7.50, the \$2.50 price reduction is a  $33\frac{1}{3}$  per cent markdown (i.e.,  $\$2.50/\$7.50$ ).

Markdowns do not appear on the operating statement, since the first item on the statement is gross sales and markdowns occur before sales are made. Notice, however, that "allowances to customers" does appear on the operating statement, and such allowances can properly be viewed as markdowns. Most markdowns occur before sales are made, but some keep sales from becoming unmade! To illustrate this point, again consider the ashtray example. Suppose the gift shop proprietor had actually sold the ashtray at the \$10 price, but the customer became dissatisfied with the purchase and brought it back to the store. The proprietor, seeking not only to keep the sale from coming undone but wanting to keep the customer's goodwill, might say "Keep the ashtray and I'll grant you a \$2.50 allowance." If the customer agrees, the accounting system will show \$10 as the original sale, \$2.50 as the allowance to the customer, and \$7.50 as the net amount of the transaction. Because markdowns and allowances to customers are both downward adjustments in price, merchants ordinarily lump both together in calculating the markdown ratio for the operating period. Although the accounting system automatically records data on allowances to customers, a supplementary record system is required for obtaining data on other markdowns.

All merchants should recognize that every item in their stocks carries some possibility of having to be marked down. Such markdowns can occur either before or after sales are made. Both types should be taken into account in setting original selling prices, for the total of original markups should be sufficiently high that subsequent markdowns will not reduce sales below the total of cost of goods sold and expenses. The formula, then, for computing the markdown ratio is:

$$\text{Markdown \%} = \frac{\$ \text{ Allowances to Customers} + \$ \text{ Markdowns}}{\text{Net Sales}}$$

One additional comment must be made about this formula. The markdown percentage is computed for an operating period. The accounting system provides the figures on allowances to customers and net sales, and the supplementary record furnishes the figure for dollar markdowns taken during that period. This means, then, that some marked-down items probably have not been sold and are still in stock. Entries are made in the supplementary markdown record at the time markdowns are taken, not at the time marked-down items are sold.

The markdown ratio is a useful analytical tool and control device. It provides information needed in planning original markups, and its existence serves as a reminder to pricesetters that prices have to be set (sooner

or later) at prices customers are able and willing to pay. If the original markup is too high to satisfy the market, markdowns are inevitable, but if the original selling price is realistic, markdowns are unnecessary. The markdown ratio is used, too, as a measure of the efficiency of store buyers and retail sales personnel, since reasonably low markdowns are an indication of effective buying, realistic pricing, and good selling. When used as a performance measure in this way, however, management should define what it considers a "desirable" markdown ratio to serve as the standard against which buying and selling efficiency can be appraised. Such standard markdown ratios are derived either through studies of store markdown ratios over past periods or from reports of trade associations revealing the markdown experiences of stores in different lines of trade and of various sizes.

### *Stockturn*

The stockturn rate is another analytical tool used by management for measuring operating efficiency. This rate indicates the speed at which the inventory "turns over"—the number of times the average inventory is sold during an operating period. If a retailer, for instance, starts the year with an inventory having a cost value of \$20,000 and ends the year with a \$30,000 inventory valued at cost, we will assume his average inventory at cost value has been \$25,000. If the cost of his goods sold during the year amounted to \$100,000, we say that his business had a stockturn rate of 4, calculated as follows:

$$\text{Stockturn Rate} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory at Cost}} = \frac{\$100,000}{\frac{1}{2}(\$20,000 + \$30,000)} = 4$$

This retailer, in other words, sold his average inventory four times during the year, or once every three months. If this retailer makes a net profit of three cents every time he sells something which cost him a dollar, we can say he had a return of 12 cents (3 cents  $\times$  4) on each dollar invested in the inventory during the year.

We computed the stockturn rate above by the method most commonly used by retailers and wholesalers. Both the numerator and denominator in the formula were expressed in terms of cost figures which are readily available from the accounting records. Inventories, both opening and closing, are commonly valued at cost and, of course, so is the cost of goods sold. There are, however, some businesses, mostly department stores but also some other large retailers, which value their inventories at resale prices rather than at original replacement cost. These businesses, to put it another way, value their inventories in terms of selling prices rather than in terms of costs, and are said to use the "retail method" of in-

ventory valuation. In such businesses, the following formula is used for computing the stockturn rate:

$$\text{Stockturn Rate} = \frac{\text{Net Sales (\$)}}{\text{Average Inventory @ Selling Price}}$$

Thus, for example, a department store using the retail method of inventory valuation might start the year with a \$100,000 inventory at retail and end it with an inventory of \$80,000 at retail, or an average of \$90,000. If net sales during the year were \$720,000, the stockturn rate would be 8 (i.e., \$720,000/\$90,000). Notice that the only real difference between this formula and the earlier one is that here we express the numerator and denominator in terms of selling price rather than in terms of cost. Whenever the stockturn rate is to be computed, both the numerator and denominator always have to be in the same terms.

This leads us to the third method of computing stockturn rate—by dividing sales in units by the average inventory in units. The formula, then, for this calculation is:

$$\text{Stockturn Rate} = \frac{\text{Sales (Total Units)}}{\text{Average Inventory in Units}}$$

This formula is used mainly in two types of situations. One concerns the store which handles only one main product, such as shoes or ice cream, making it practical to record sales and inventories in terms of merchandise units—i.e., in pairs of shoes or gallons of ice cream. The second type of situation involves the management of a retail or wholesale firm which wants to determine how rapidly its stock of a given item, such as tall cans of *Carnation* milk, is turning over. Management might want this information, for instance, in order to determine whether or not the inventory of the item is of optimum size, and whether the maximum return on the investment in the inventory of the particular item is being obtained. Not many businesses keep track of their inventories and sales in units by type of item for all their stocks, although some stores, such as those handling “high fashion” merchandise, do find it advisable to maintain such unit control. Most retailers of more staple items, such as groceries and drugs, carry so many types, brands, and sizes of items that they find it more convenient to employ a common denominator for purposes of computing stockturn rates for their entire businesses, for individual departments, or for other segments of their operations. The dollar, of course, is the common denominator most convenient for these purposes. For example, a retail grocer who stocks ice cream, many brands and sizes of canned and frozen fruits and vegetables, and literally thousands of other items, does not even attempt to add gallons of ice cream to cans of string beans to units of all the other items. He simply converts

them all into dollar values, either at retail or at cost prices, and only then does he make his stockturn calculations.

The stockturn rate provides a yardstick for measuring operating efficiency. An increase in the rate of turnover of capital invested in inventory will normally increase total profits, unless the net profit ratio is decreased proportionally. Thus, a higher stockturn is a much sought after goal of management. The stockturn rate is also used as a basis for comparing the effectiveness of competing branch operations or retail outlets. The unit with the highest stockturn rate is probably the most efficiently managed. However, this is not always true. An example will illustrate this point. Suppose, now, that in a given retail shoe chain Store A in some year carried an average inventory of 1,000 pairs of shoes and sold 3,000 pairs during the year, giving it an annual stockturn rate of 3 (i.e.,  $3,000/1,000$ ). Store B in the same chain had an average inventory of 1,500 pairs and sales of 3,000 pairs, giving it a stockturn rate of 2 (i.e.,  $3,000/1,500$ ). Which of these two stores was the more efficient? Offhand, we might conclude that A was more efficient than B, since A reached the same sales level as B and did so with a smaller average inventory. But wait! Do we really have all the facts we need to judge this case? Isn't this a good example of a situation where we need some qualitative information before we can do a good job of interpreting quantitative information—i.e., the two stockturn rates? Where, for instance, are A and B located? A, the store with the fastest stockturn rate, might be across the street from the shoe factory with the opportunity to replenish inventory daily while B is 3,500 air miles away in Anchorage, Alaska with the necessity of maintaining a large reserve inventory. Also, supposing A catered only to men, while B carried shoes for the whole family, necessitating a much larger basic stock? Or, perhaps, A handled only low-priced, low-margin shoes, while B specialized in higher-priced, high-margin shoe lines. These and similar considerations should cause us to be cautious in drawing conclusions based on differences in stockturn rates among stores. Of course, such considerations are less likely to be important when the stockturn rate is used in comparing the operating efficiency of the same store during two different time periods.

#### **BREAK-EVEN ANALYSIS**

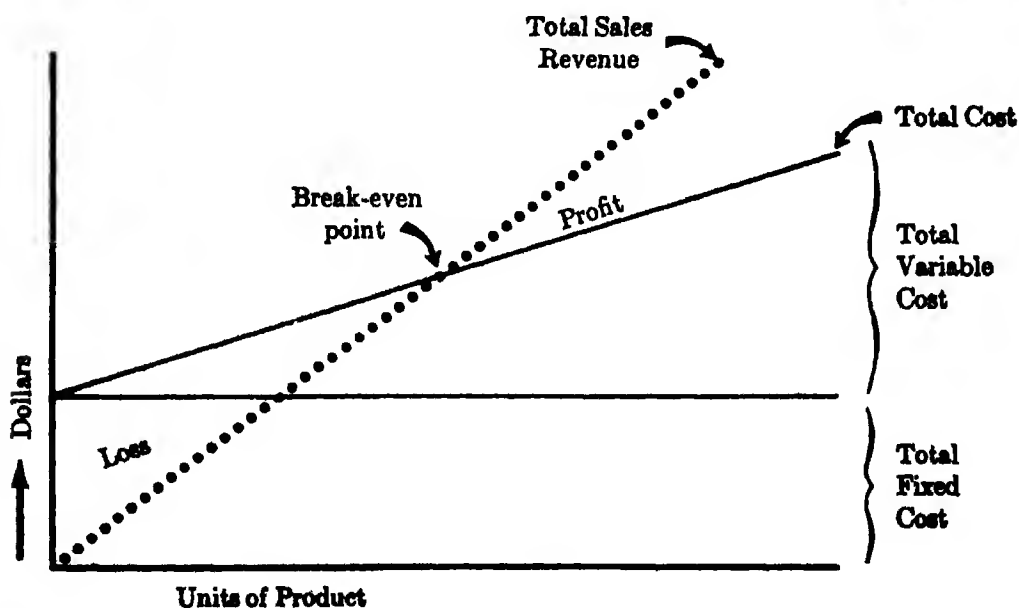
Break-even analysis is used by marketing executives for analyzing problems involving operating data. It is a technique for studying how costs vary at different levels of sales volume and, because the interrelationship of costs and sales volume determines the amount of profit (or loss), break-even analysis helps in estimating the effects on net profits of various alternative solutions to a given marketing problem. The technique can be used, for example, to show the likely effects on net profit of op-

erating at different sales volumes, of pricing the product at various prices, of changing the sales compensation method, and of altering the amounts invested in advertising. Break-even analysis, in other words, can be helpful in analyzing any marketing problem in which alternative solutions differ as to their impact on costs and/or sales volume. For example, Alternative A may increase costs and result in a more-than-offsetting increase in sales volume, while Alternative B may decrease costs with sales volume staying about the same as before. Break-even analysis provides a technique for evaluating the relative effects on net profit of such alternatives.

#### Break-Even Chart

Figure 12.3 shows a typical break-even chart. Notice that the break-even point occurs at the operating level where total costs equal total

Figure 12.3



sales revenue. This point, in other words, tells us the number of units of product which must be sold at a particular price in order for the firm to barely cover its total costs. If sales volume goes beyond this point, each additional unit of product sold brings in some net profit. Each sale before reaching this point is at a loss.

Notice particularly that in order to construct a break-even chart, costs must be segregated into two categories—fixed and variable. All costs, of course, are variable over very long periods of time, but in shorter periods (as are implicit in the notion of break-even analysis) some costs do not vary with the output rate and are known as “fixed costs.” Other costs vary more or less proportionately to and automatically with the

output rate and are called "variable costs." Examples of costs usually classified as fixed, at least in the short-run, include salaries, rent, heat, light, depreciation, local property taxes, bond interest, and promotional expenses. Examples of variable costs, those that vary proportionately and somewhat automatically with the quantity produced or sold, include costs of raw materials, direct labor (when on a piece rate or hourly basis), salesmen's commissions, and costs of packaging, packing, warehousing, and shipping.

The two-way classification of costs into fixed and variable still leaves unresolved the problem of those costs which are partly fixed and partly variable. Consider, for instance, the expense item "bookkeepers' salaries." A small sales increase might not increase this expense at all, since the present bookkeeping force probably could handle the small extra work load. But if sales should rise markedly, say by 25 or 30 per cent, more bookkeepers would have to be hired, causing an increase in the expense item "bookkeepers' salaries." The simplest and most practical way to resolve this classification problem is to count any cost as fixed if its amount is not completely variable in relation to the quantity of output. Therefore, for purposes of making break-even calculations, semi-fixed costs are treated the same as though they were wholly-fixed costs.

#### Computation of Break-Even Point

If we want to determine the break-even point mathematically rather than graphically, there are three steps to go through. The first, which is also needed for graphic break-even analysis, is to total up *fixed costs for the operating period* (at a predetermined volume of output) and *variable costs per unit*. Second, calculate the *unit contribution to fixed costs* as follows:

$$\begin{array}{ccccc} \text{Unit Contribution} & & \text{Selling Price} & & \text{Variable Costs} \\ \text{to Fixed Costs} & = & \text{per unit} & - & \text{per unit} \end{array}$$

This unit contribution figure indicates the portion of the unit selling price which, after deduction of variable costs, will be left over and which can be applied against the fixed costs. The third step is to compute the break-even point itself—i.e., the total number of units which have to be sold in order to cover total fixed costs. The following formula is used for this computation:

$$\begin{array}{ccc} \text{Break-Even Point} & = & \frac{\text{Total Fixed Costs}}{\text{Unit Contribution to Fixed Costs}} \\ \text{(in units)} & & \end{array}$$

If we now multiply *break-even unit volume* by the *selling price per unit*, we can simply and quickly calculate the dollar sales volume needed to reach the break-even point.

**ILLUSTRATION OF BREAK-EVEN CALCULATION.** Assume that the Empire Hatchet Company has total annual fixed costs of \$40,000, variable costs per unit of \$1.50, and plans to price its hatchets at \$3.50 apiece. How many hatchets must Empire sell during the year in order to break even? Empire's unit contribution to fixed costs is \$3.50 - \$1.50, or \$2.00 per unit, and the break-even unit volume is:

$$\frac{\text{Total Fixed Costs}}{\text{Unit Contribution}} = \frac{\$40,000}{\$2.00} = 20,000 \text{ units}$$

Thus, if Empire sells 20,000 hatchets, it will cover all its fixed and variable costs. If it sells the 20,001st hatchet, Empire will show a profit—one of \$2.00.

To obtain the break-even point in dollars, simply multiply break-even unit volume (20,000 hatchets) by selling price (\$3.50), which yields \$70,000. To check this, add total fixed costs (\$40,000) to variable costs per unit multiplied by break-even unit volume (\$1.50 × \$20,000, or \$30,000), which means that total dollar costs also come to \$70,000. At the break-even point, total dollar costs always equal total dollars of sales revenue.

**BREAK-EVEN ANALYSIS AND EVALUATING DECISION ALTERNATIVES.** Suppose, now, that Empire goes ahead and prices its hatchets at \$3.50 and sells 30,000 hatchets, all it can produce with its present plant capacity. Management is fairly certain that 20,000 more hatchets could be sold at the \$3.50 price, and estimates that the needed additional plant capacity would cause annual fixed costs to rise by \$20,000; however, because of the greater output and improved production efficiency, variable costs would be brought down to \$1.00 per unit. Should the plant be expanded to produce a total of 50,000 hatchets? Or should the company continue with a plant which allows it to sell no more than 30,000 hatchets annually? In this example then (admittedly an oversimplified one since in real life there would be many more alternatives), we have only two decision alternatives to evaluate: (A) expand the plant or (B) don't expand it.

If management selects Alternative A, the break-even point will rise by 4,000 hatchets, or \$14,000. But if management's estimate that 50,000 hatchets can be sold as easily as 30,000 is correct, annual profits will more than triple, rising from \$20,000 to \$65,000. Thus, in using break-even analysis as an aid to decision-making, we have shown that it is not enough to compute only the break-even point. The decision-maker must also take into consideration the likely changes in sales volumes that will occur with each alternative, at the same time he considers how

fixed costs and unit variable costs will change. In other words, management is really more interested in the amount of profit at different sales volumes than it is in break-even points as such.

	Alternative A (Expand Plant)	Alternative B (Don't Expand Plant)
1. Total Fixed Costs	\$ 60,000	\$ 40,000
2. Variable Costs per Unit	1.00	1.50
3. Cont./Unit @ \$3.50 Price	2.50	2.00
4. Break-Even Unit Volume 1. + 3.	24,000 units	20,000 units
5. Break-Even Dollar Volume 4. × \$3.50	\$ 84,000	\$ 70,000
6. \$ Volume @ Plant Capacity (Selling Price × Capacity)	\$175,000	\$105,000
7. Total Fixed Costs	\$60,000	\$40,000
8. Total Variable Costs (VC/Unit × Capacity)	50,000	45,000
9. Total Costs @ Capacity	110,000	85,000
10. Annual Profit @ Capacity	\$ 65,000	\$ 20,000

#### Appraisal of Break-Even Analysis

The above illustrations have served to indicate that break-even analysis can be a useful tool in decision-making. But this tool has a serious limitation in that it uses the "net profit" rather than the "contribution to profit" approach to problems.<sup>3</sup> The break-even point, by definition, is the volume where sales revenue equals total costs, both variable and fixed. Break-even analysis, then, considers total costs, rather than only those that are affected by the decision which would be consistent with the contribution-to-profit decision criterion. Because of this failure to formulate the problem in terms of the appropriate decision criterion of contribution to profit, break-even analysis has a serious conceptual defect for decision-making purposes.

But even with this defect, break-even analysis is still useful as a tool to aid in decision-making. There are, according to Professor Howard, at least two types of situation where break-even analysis can help the decision-maker: (1) those where management is seeking to determine whether a problem exists, and (2) those where management in making decisions must consider the effects on net profit as well as on contribution to profit.<sup>4</sup> We can illustrate these two types of situations as follows:

<sup>3</sup> J. A. Howard, *Marketing Management: Analysis and Decision* (Homewood, Ill.: Richard D. Irwin, 1957), p. 175.

<sup>4</sup> *Ibid.*, p. 178.



1. *To aid in determining whether a problem exists.* Suppose, for instance, that the management of a department store is considering the question as to how the store might fare during a period of economic recession. By combining break-even analysis with estimates of the effect of falling consumer incomes on department store sales, the management might gain insight on whether a recession might present the store with a serious problem.
2. *To assist in decision-making, when management must consider effects on net profit as well as on contribution to profit.* Large advertising outlays in a current year, for instance, might result in the greatest long-term contribution to profit, but accounting practice is to classify such outlays as current expense. If management feels that stockholders will become disgruntled over a lower level of net profits in the near-term, it might decide not to select the alternative which would be the most profitable in the long-run. Break-even analysis can be used in such situations to suggest the net profit effects of different decision alternatives.

### SALES ANALYSIS

Sales analysis consists of a thorough and detailed study of the company's sales records with the purpose of detecting marketing strengths and weaknesses. Although sales records are, of course, regularly summarized in the "sales" section of the operating statement, such summaries reveal next to nothing about either strong or weak features of the company's marketing efforts. Through sales analyses made at periodic intervals, management seeks to gain insights concerning such matters as: the sales territories where it is strong and where it is weak, the products responsible for the most and the least sales volume, and the types of customers who provide the most satisfactory and the least satisfactory sales volume. Sales analysis, then, is used by management to uncover significant details which otherwise lie hidden in the sales records. It provides the pertinent items of information management needs in order to allocate future marketing efforts along lines which will bring greater return.

#### *Misdirected Marketing Effort*

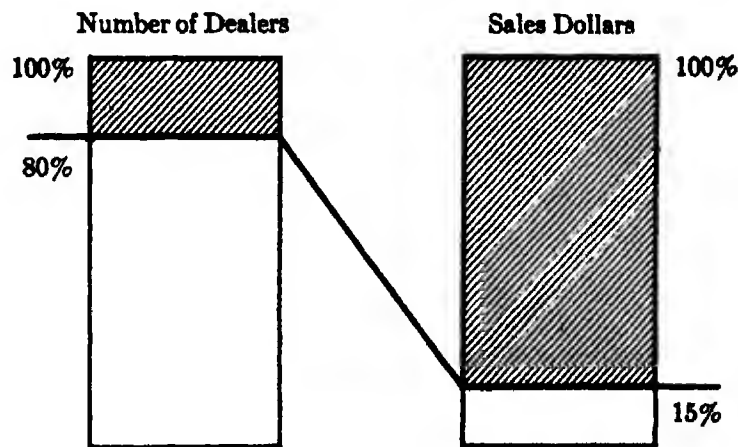
In most businesses, a large percentage of the customers, territories, orders, or products bring in only a small percentage of the sales. One sales executive used the diagram on page 291 to illustrate this situation. He said "the column on the left represents our total number of dealers, and the column on the right our total dollar sales volume. The diagonal indicates that about 80 per cent of our customers give us less than 15 per cent of our volume."<sup>5</sup> Similar situations can be found in most com-

<sup>5</sup> Quoted in: C. H. Sevin, *How Manufacturers Reduce Their Distribution Costs* (Washington, D.C.: U.S. Government Printing Office, 1948), U.S. Dept. of Commerce, Economic Series No. 72, p. 1.

panies, a large percentage of the customers accounting for a small percentage of the total sales and, conversely, a small percentage of customers accounting for a high percentage of total sales. And comparable situations are found where a large percentage of the sales territories, products, and orders bring in only a small percentage of total sales.

Such sales patterns do not always result in unprofitable operations, but operations are often less profitable than they would have to be. Now, why is this so? Simply because marketing efforts and, hence, marketing costs all too frequently are divided on the basis of customers, territories, products, orders, and so forth, rather than on a basis of actual or po-

Figure 12.4



tential dollar sales. It usually costs, for example, just as much to maintain a salesman in a good territory as in a bad one, almost as much to promote a product that sells in large volume as one that sells slowly or not at all, and as much to have a salesman call on and service a customer who gives the company large orders as on another who orders in small quantities. It is not at all uncommon for a large proportion of the total spending for marketing efforts to result in only a very small proportion of the total sales and profits. The first step management can take to improve such situations is to learn of their existence, and that is the important task assigned to sales analysis.

#### *Nature of Sales Records*

Before we work through an illustrative problem in sales analysis, we must examine the sales records which serve as the source of data. Companies vary greatly in the type and form of information they have available on sales. At one extreme, some have no information other than that recorded by the accountants as sales are made and, of course, carbons of customers' sales invoices. At the opposite extreme, other companies

maintain sales records in great detail and have information readily available and in usable form for making sales analyses by individual salesmen, by types of products, by classes of customers, by sizes of orders, and by other pertinent classification systems.

Whether a particular company lies at one of these extremes or somewhere in between, the most important sources of data useful in sales analysis are the files of customers' sales invoices. Each sales invoice typically contains two types of information, both of which are essential for sales analysis. Each invoice has information which identifies and describes the customer (e.g., his name and geographic location), and each contains data on the specific transaction (e.g., the date of the order, the products sold and the quantities, the price per unit, total dollar sales per product, and total dollar amount of the order). Companies with highly developed systems of sales analysis have been careful to organize these basic items of sales information systematically—i.e., in ways which facilitate analysis. In more and more companies, these significant data are punched onto cards and fed into electronic data processing equipment whenever sales analyses are desired.

#### *Specific Purposes of Main Types of Sales Analyses*<sup>6</sup>

Earlier we said that the purpose of sales analysis was to detect marketing strengths and weaknesses. Each of the main types of sales analysis is used to shed light on a different aspect of these strengths and weaknesses. Analysis of sales by territories answers the question of how much is being sold *where*. Analysis of sales by products answers how much of *what* is being sold. Analysis of sales by customers answers the question of *who* is buying how much. Notice that all types of sales analysis relate to the question of *how much* is being sold, but each answers this question in a different way. Notice, too, the important fact that although sales analyses can identify different aspects of marketing strength and weakness, it cannot explain *why* they exist. The 'why' question is the province and responsibility of the marketing manager, but he can, at least, look to sales analysis to "put the finger on" specific strengths and weaknesses—a necessary preliminary to any explanations of why they exist.

#### *Illustrative Problem—Sales Analysis*

We present, in this section, an illustrative sales analysis used for the purpose of determining the relative importance of different categories of customers. The general approach shown here applies not only to customer sales analysis but to other types such as product sales analysis and territorial sales analysis. Essentially, any sales analysis must proceed

<sup>6</sup> This explanation is adapted from: R. D. Crisp, *Marketing Research* (New York: McGraw-Hill, 1957), p. 134

through three steps: (1) establishment and definition of classifications to be analyzed (e.g., customer groupings, product groups, or territorial areas), (2) tabulation of sales data according to the classification system being used, and (3) presentation of the results in terms meaningful to management.

Our illustrative problem concerns a manufacturer whose products reach final markets through several different types of middlemen—i.e., his products move through a number of different channels of distribution.<sup>7</sup> The products are consumed mainly by industrial users but some also find their way into the hands of ultimate consumers. Although a few orders are sold directly to industrial users, most of the company's output is sold through various types of middlemen. This sales analysis by class of trade, then, proceeds as follows:

**STEP ONE—ESTABLISHMENT OF CUSTOMER CLASSIFICATIONS.** In some companies, there is no need for this step, since the company may have already established customer classifications—e.g., by adhering to a stated distribution policy specifying the types of accounts from whom business is solicited. When no such clear-cut policy is in effect, the sales records have to be examined closely to identify the different classes of customers from whom business is being obtained, and to establish various categories accordingly. We assume in this hypothetical company that it is necessary to examine the sales records; the examination shows that the customers can be classified as follows: industrial distributors, automotive parts wholesalers, hardware wholesalers, combination hardware wholesalers and industrial distributors, miscellaneous types of wholesalers, retailers, and direct accounts.

**STEP TWO—TABULATION OF SALES TO EACH CLASS OF TRADE.** We assume, in our example, that the company maintains individual customer account sales records, and that these records are on punched cards. This is a very fortunate assumption, indeed, for otherwise it would be necessary to go through the tedious process of sorting and tabulating original invoices prior to the tabulation we are concerned with here. As the sales records stand, however, all that has to be done is to set up a code for each customer classification, have the individual cards for customers punched according to this code, and run the cards through a data processing machine in order to sort out those for each customer grouping, and tabulate the total sales for each group.

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<sup>7</sup> This illustration adapted from: C. W. Smith, *Making Your Sales Figures Talk* (Washington, D.C.: U.S. Government Printing Office, 1953), Small Business Administration, Small Business Management Series No. 8, pp. 24-26. The reader who wants to examine other illustrations of sales analysis will profit greatly from reading this interesting booklet.

**STEP THREE—PRESENT THE RESULTS IN MEANINGFUL TERMS.** Exhibit 12.2 shows the results obtained by machine tabulation:

**Exhibit 12.2**  
**Results of Machine Tabulation of Sales by Class of Customer**

<i>Class of Customer</i>	<i>Number of Accounts</i>	<i>Total Sales During 196 — (Rounded to nearest \$10,000)</i>
Industrial Distributors	1,097	\$ 4,200,000
Automotive Parts Wholesalers	789	3,450,000
Comb. Hardware Wholesalers & Industrial Distributors	256	1,700,000
Hardware Wholesalers	206	200,000
Misc. Wholesalers	410	130,000
Retailers	666	150,000
Direct Accounts	917	170,000
<b>Totals</b>	<b>4,341</b>	<b>\$10,000,000</b>

This information, although interesting, still is not in very meaningful form, so we will recast it in an attempt to bring out its significance. We can, in this illustration, do three main things to improve the presentation of the data: (1) present the statistics on sales and classes of accounts in terms of percentages, (2) calculate the average sales per outlet for each customer class, and (3) regroup the resulting data into two major categories—"wholesalers" and "all other." After these recastings, we have Exhibit 12.3.

**Exhibit 12.3**  
**Analysis of Sales by Class of Customers**

<i>Class of Customer</i>	<i>% of Total Customers (nearest 1%)</i>	<i>% of Total Sales</i>	<i>Average Sales per Outlet</i>
<b>WHOLESALEERS</b>			
Industrial Distributors	25%	42%	\$3,830
Auto Parts Wholesalers	18	34.5	4,370
Comb. Hardware Wholesalers & Industrial Distributors	6	17	6,630
Hardware Wholesalers	5	2	970
Misc. Wholesalers	9	1.3	317
<b>Total Wholesalers</b>	<b>63%</b>	<b>96.8%</b>	<b>\$3,546</b>
<b>"ALL OTHER"</b>			
Retailers	15%	1.5%	\$ 225
Direct Accounts	22	1.7	185
<b>Total "All Other"</b>	<b>37%</b>	<b>3.2%</b>	<b>\$ 202</b>
<b>TOTAL—ALL CUSTOMERS</b>	<b>100%</b>	<b>100.0%</b>	<b>\$2,203</b>

Now what has this customer sales analysis revealed? It shows, for one thing, that 37 per cent of the customers (the "all other" grouping) account for only a little more than 3 per cent of sales and average orders only about  $\frac{1}{17}$ th the size of those submitted by the average wholesaler. For another thing, it shows that the large orders come from just three classes of wholesalers, who together comprise 49 per cent of the total customers, but who also account for 93.5 per cent of total company sales.

In short, our sales analysis has answered the question "Who buys how much?" but not the "Why?" Management would have to provide an explanation as to why this situation exists, and this explanation might lead to a thorough reappraisal of a distribution policy that results in such a pattern of sales volume.

### ANALYSIS OF MARKETING EXPENSES

Sales analysis helps a marketing executive evaluate the sources of his company's sales volume, and the next logical step in appraising the effectiveness of its marketing efforts is to analyze marketing expenses. Before management can reformulate marketing policies in line with the objective of obtaining maximum long-term profits, it has to know what variations there are in the expenses of securing each segment of total sales volume. The analysis of marketing expenses has developed into a complex subject with many ramifications, and there are almost countless analytical techniques in use.<sup>8</sup> In this discussion, we are interested in the ways marketing management can use marketing expense analyses rather than in the details of their preparation. The uses of such analyses can be shown effectively by seeing how one company analyzed the comparative costs of serving city and small town markets.<sup>9</sup>

#### Case Illustration—Marketing Expense Analysis

**BACKGROUND OF SITUATION.** Laidlaw Manufacturing Company distributed its line of consumer products through a sales force which called directly on retail stores in cities and towns of all sizes. Laidlaw sales executives had believed that big-city business was much more profitable than that from smaller towns, so sales and advertising efforts were concentrated on the big-city outlets. This belief was based mainly on the assumption that big retail stores are located in big cities, while smaller stores are in the smaller towns. This assumption, however, was not borne out by a survey made by the company which showed that among the

<sup>8</sup> The reader interested in delving deeply into this subject should consult: D. R. Longman and M. Schiff, *Practical Distribution Cost Analysis* (Homewood, Ill.: R. D. Irwin, 1955), or J. B. Heckert and R. B. Miner, *Distribution Costs* (New York: Ronald Press, 1953).

<sup>9</sup> This case illustration adapted and summarized from: C. H. Sevin, *op. cit.*, pp. 86-90.

retail outlets carrying the company products, there were many fairly large stores in small towns and many small stores in big cities. These survey results led the executives to undertake studies seeking an answer to the question: "Where can we distribute most profitably?" This over-all question was broken down more specifically into three sub-questions:

1. What types and sizes of outlets offer the greatest opportunity for profitable transactions?
2. In what sizes of towns are these profitable types of outlets located?
3. At what point is it more profitable to send sales and advertising dollars into smaller markets, instead of further saturating big-city markets?

**CLASSIFICATION OF ACCOUNTS AND INITIAL ANALYSIS.** The first step was to segregate the customers into four sales-volume classifications (A, B, C, and D) based on their annual purchases from Laidlaw, and to determine the relative profitability of each classification. This step required that total marketing expenses be allocated to each customer, after which the expenses applicable to each classification could be deducted from the sales volume accounted for by each and the profitability determined. It was decided, therefore, to allocate marketing expenses to customer classification as follows: selling expenses were apportioned on the basis of the number of calls made by salesmen; sales office and credit expenses on the basis of the number of customers' orders; handling, warehousing, and delivery expenses on the basis of number of packing cases of product sold. The results of this analysis are shown below:

Customers, Sales, Orders,  
Distribution Costs, Gross Margins, and  
Net Profit or Loss, by Customer-volume Groups

<i>Customer-volume groups, annual volume purchases</i>	<i>Percent of total number of customers</i>	<i>Number of sales calls per \$1000 of sales</i>	<i>Number of orders per \$1000 of sales</i>	<i>Sales and handling cost per \$100 of sales</i>	<i>Gross margin per \$1000 of sales</i>	<i>Net profit or loss per \$1000 of sales</i>
A. \$50,000 and over	10.9%	26	15	\$ 85	\$236	\$151
B. \$30,000 to \$50,000	21.9	70	22	171	251	80
C. - \$10,000 to \$30,000	28.7	213	49	467	285	182 *
D. Under \$10,000	38.5	757	100	347	302	545 *
Total or average	100.0%	84	38	\$186	\$258	\$ 72

\* Loss

As this table revealed, there were tremendous differences in the amount of effort needed to get \$1,000 worth of sales from customers in different volume classifications. Although an average of only 26 calls were made by salesmen in order to get \$1,000 in sales from A-type customers, it was necessary to make 757 calls on D-type customers and prospects to obtain the same sales volume. Fifteen orders from A-type customers produced \$1,000 in sales, but it took 100 orders from D-type customers to get the same amount of sales. The ratio of calls to orders was less than two to one for A-type customers, but more than seven to one for D-type customers.

The results showed further that C- and D-type customers were unprofitable as a group. The C group were responsible for a net loss of 18 per cent of sales, and D accounts caused the company to lose more than 54 per cent of every sales dollar—eating up profits the company made on A and B accounts. Examination of other sales records also revealed that these unprofitable accounts (i.e., C- and D-type customers) made up more than two-thirds of all the active accounts.

**CUSTOMER ANALYSIS BY CITY SIZE.** The next step was to tabulate all customers into two groups, one made up of A- and B-types and the other of C- and D-types, according to the size of city in which they were located. The results of this analysis are shown below:

Distribution of Customer-volume Groups by Size-of-City Groups  
(Percentage of Totals)

<i>Size-of-city-group</i>	<i>Customer-volume group</i>		<i>Total all customers</i>
	<i>A and B customers</i>	<i>C and D customers</i>	
500,000 and over	26.0%	74.0%	100.0%
100,000-499,999	32.4	67.6	100.0
30,000-99,999	36.0	64.0	100.0
10,000-29,999	42.2	57.8	100.0
2,500-9,999	39.7	60.3	100.0
Under 2,500	26.8	73.2	100.0

This analysis revealed, in other words, that the ratio of profitable (A plus B) accounts to total accounts reached a peak of 42.2 per cent in the cities of 10,000 to 29,999 population. In fact, the ratio of profitable (A plus B) accounts to total accounts was higher in every size of town—including towns under 2,500—than it was in large cities of over 500,000 population.

By way of contrast, 74 per cent of the customers in the largest cities were in the unprofitable (C and D) groups. This prompted executives to examine sales records of individual customers more closely. They discovered that over half of the A-type customers with annual purchases



of \$50,000 and over were located in towns coming within the three smallest population brackets—towns with less than 30,000 people. Average sales to A and B customers in even the smallest towns was several times that of unprofitable C and D stores in the large cities. But, A and B customers in places of over 30,000 population were of larger average size than A and B customers in smaller places. Furthermore, executives realized that Laidlaw salesmen had to travel farther in order to reach the large stores in the small towns.

The next step, accordingly, was to find out whether there were variations in marketing expenses and profits by size of city as well as by volume of customers' purchases. Consequently, the data underlying the figures shown in the previous table were reclassified, resulting in a tabulation of marketing expenses and net profit or loss for profitable and unprofitable accounts in each size of city. The results of this tabulation are shown below:

Net Profit or Loss per \$1,000 of  
Sales for Customer-volume Groups by Size-of-city Groups

<i>Size-of-city group</i>	<i>A and B customers</i>	<i>C and D customers</i>
500,000 and over	\$102	\$-303
100,000-499,999	112	-261
30,000-99,999	121	-252
10,000-29,999	116	-274
2,500-9,999	108	-287
Under 2,500	91	-353

Much to the executives' surprise, the highest rate of profit per \$1,000 of sales, \$121, was obtained from A and B customers in cities within the 30,000 to 99,999 population bracket, rather than from those in the large cities. In fact, A and B stores in the large cities were, as a group, less profitable per \$1,000 of sales than A and B stores in cities in all other population brackets except those under 2,500 population. Further analysis uncovered the reasons for this. It was found that A and B accounts in small towns ordered much less frequently and placed much larger orders than comparable customers in large cities, so that their lower selling and handling costs more than compensated for the higher traveling expenses required to solicit their orders. This led to a related study of the average order size of the different customer classifications with the following results:

<i>City-Size Groups</i>	<i>A Accounts</i>	<i>B Accounts</i>	<i>C Accounts</i>	<i>D Accounts</i>
Small towns	\$38	\$27	\$19	\$12
Large cities	25	18	6	5

This same study revealed that A and B accounts in the smaller towns were, on the average, growing faster than big-city A and B class customers. In addition, company salesmen stated that the smaller-town stores usually were more cooperative than larger-city retailers in arranging for displays and special promotions.

**INTERPRETATION OF EXPENSE STUDY RESULTS.** Executives felt that the analysis of marketing expenses had answered the question as to where the company could distribute most profitably. The answers, as follows were contrary to some of the executives' previously-held notions:

1. A and B accounts were generally profitable, where C and D customers, those buying under \$30,000 annually, were generally unprofitable. The volume from C and D accounts represented less than 15 per cent of total sales volume, yet they absorbed more than 75 per cent of the time of Laidlaw salesmen.
2. The net profit per dollar of sales on A and B customers was larger for customers located in towns with 2,500 to 499,999 population than for the big-city A and B customers. Moreover, more than half the profitable A and B volume was from customers in small towns.

**POLICY CHANGES AND OTHER EXECUTIVE ACTION.** These findings led executives to make some drastic changes in company marketing policies. In the first place, they asked themselves whether the sales volume from the unprofitable C and D customers in the larger cities was necessary in order to obtain low unit costs of production. Spot studies showed that Laidlaw was getting less than a third of the potential business from A and B accounts in the smaller towns, whereas the company was obtaining from two-thirds to over three-quarters of the business of C and D accounts in the larger cities. Their conclusion was that by concentrating sales and advertising coverage in the big cities, Laidlaw had neglected opportunities of selling to its most profitable customers in the smaller towns. Executives figured that if they could increase company sales performance from one-third to one-half of the full sales potential of the A and B accounts in the smaller towns (by more intensive personal salesmanship, point-of-purchase material, and advertising) then Laidlaw could increase its volume by about three times the total sales obtained from the C and D accounts. The company could in this way get more volume at lower cost and with much more profit.

They decided to shift Laidlaw salesmen from calling on all C and D accounts and have them intensively cover the A and B customers—es-

pecially those in smaller towns. Instead of making 12 to 15 personal calls on C and D customers per year, it was decided to cover these accounts by direct mail. Cost estimates showed that if mail solicitation was to be used instead of salesmen, a minimum-sized order of about \$15 could be handled profitably. Many small-town C and D customers had been giving Laidlaw orders of this size and executives hoped to retain most of this business. On the other hand, the company stood ready to lose the business of unprofitable C and D accounts in large cities, because executives knew that competitors would be quick to grasp the advantage when Laidlaw salesmen stopped calling on such accounts. Executives, however, said they would not regret this loss to competitors, because the orders involved were too small to handle profitably even by mail. A letter was drafted and sent to a selected list of C and D accounts explaining the change in policy, and this was followed by regular monthly mailings soliciting orders. It turned out that most of the small dealers in the smaller towns continued to order in about the same quantities as they had when called on by salesmen. Thus, the change in policy converted these accounts into profitable ones, by virtue of the decreased costs of solicitation.

Decisions were made also to change certain advertising policies. Instead of concentrating advertising coverage on the big cities, as had been done previously, it was decided to concentrate on the most profitable part of the market. Executives reasoned that newspaper and spot radio advertising which reached consumers who bought from profitable dealers was more valuable to the company than that reaching consumers buying from the unprofitable outlets. They decided, therefore, that instead of using saturation coverage in a short list of large cities, to direct the bulk of the advertising effort to consumers who might buy from the profitable stores in a longer list of smaller cities.

If a particular newspaper or radio station had a circulation or coverage which concentrated on consumers who bought where the profitable stores were located, executives considered that paper or station as a "first buy," regardless of whether or not it had the largest circulation or coverage in the area involved. Similar policies were formulated with respect to the frequency of insertion and size of advertisements. In short, policies and practices on advertising media selection, advertising research, and copy development were all related as much as possible to the types and locations of the most profitable outlets.

**APPRAISAL OF RESULTS OF POLICY CHANGES.** Executives decided to choose three towns in the 10,000-29,999 size bracket, each in a different geographic area, for purposes of comparing the results of six months' opera-

tions under the new policies with a similar period in the preceding year. These comparisons are shown below:

<i>Item</i>	<i>Before changes</i>	<i>After changes</i>
Gross margin, per \$1,000 of sales	\$263	\$265
Total distribution costs, per \$1,000 of sales	189	122
Net profit, per \$1,000 of sales	74	143
Index of sales (per cent)	100	123

**COMMENT.** Notice that Laidlaw accomplished a reduction of about one-third in its ratio of marketing expenses to sales, and that its ratio of net profits to sales nearly doubled. This is striking evidence of the value of the guidance furnished executives through analyses of sales volume and marketing expenses. Notice, too, that marketing expense analysis, unlike break-even analysis, can be used in ways that are consistent with the contribution-to-profit approach to decision-making. This adjustment (you should check back a few pages to see how it was accomplished) is achieved through executive judgments as to the bases on which different categories of marketing expenses should be allocated to the marketing segments being evaluated for profitability. Both sales analysis and marketing expense analysis, however, are in reality studies of past marketing history; consequently, before decisions are made on the basis of their results, executives should consider how closely future operating conditions are likely to resemble those of the past.

### CONCLUSION

Marketing decisions, although always reached in the face of some uncertainty, should be based on relevant information, gleaned both from internal and external sources. Ultimately, every marketing decision is made in the hope that it will contribute to the important goal of maximum long-term profitability. The operating statement is a summary of the relationships among financial factors affecting net profit, and as such, is the wellspring from which come most of the concepts and analytical techniques that serve as aids in the making of marketing decisions. It is the inspiration for such everyday marketing concepts as the markup, the markdown, and the stockturn rate. When break-even analysis is used as an aid in marketing decision-making, operating expense data must be rearranged, and estimates made of the probable effects of alternative courses of action on costs and sales volumes. Special tabulations of operating data, sometimes involving a reworking of such origi-

nal records as customers' sales invoices, are required for purposes of sales analysis and for marketing expense analysis, both of which play significant roles as instruments for detecting specific instances of marketing strength and weakness. Consideration and analysis of internal data are of undeniable importance to the marketing decision-maker. He can, however, appraise the full significance of operating figures only when he examines them together with relevant external data and pertinent items of qualitative information.

### **QUESTIONS AND PROBLEMS**

1. Distinguish between:
  - a. fixed and variable costs
  - b. internal and external marketing information
  - c. qualitative and quantitative marketing information
  - d. gross margin ratio and net profit ratio
  - e. markup and markdown
  - f. markup on selling price and markup on cost
2. Define the following terms:
  - a. operating statement
  - b. stockturn rate
  - c. break-even analysis
  - d. break-even point
  - e. sales analysis
  - f. misdirected marketing effort
  - g. marketing expense analysis
3. What reasoning lies behind the fact that operating ratios are usually expressed as percentages of net sales?
4. How would you account for a situation in which two companies, both in the same industry and with comparable products, had different expense ratios?
5. What are the main causes of markdowns? Why is it that *all* markdowns do not appear on the operating statement? Should a retailer strive to eliminate markdowns completely? Why? What corrective measures would you suggest to a retailer who says that his markdowns are too high?
6. Under what conditions are stockturn rates appropriate as measures of operating efficiency? What are the reasons why different businesses have different stockturn rates?
7. Summarize the various ways a marketing manager might use sales analysis. Marketing expense analysis.

8. Find the missing figures in the following table:

<i>Cost</i>	<i>Markup % on Cost</i>	<i>Markup</i>	<i>Markup % on Selling Price</i>	<i>Selling Price</i>
\$8.00		\$1.00		
\$1.50			25%	
	75%	\$2.00		
			10%	\$15.00
\$0.75	40%			
		\$5.00		\$25.00

9. Find the missing figures in the following table:

<i>Markup Percentage on Cost</i>	<i>Markup Percentage on Selling Price</i>
20%	
	35%
67%	
	17½%
200%	
-	23%
100%	
	60%

10. A retailer purchased an item for \$1.50, originally priced it at \$1.95, and finally sold it at \$1.69. What was the markdown percentage?

11. On the basis of the following operating data, calculate the 1964 opening inventory at cost:

1964 cost of goods sold	\$120,000
1964 stockturn rate	4
1964 closing inventory at cost	\$ 10,000

12. Last month Retailer A had gross sales of \$12,000, sales returns and allowances of \$500, opening inventory at cost of \$2,500, purchases at cost of \$4,000, closing inventory at cost

of \$1,500, and expenses of \$2,000. What was A's net profit? A's gross margin?

13. Last month Retailer B had cost of goods sold of \$3,000, expenses of \$2,000, and a gross margin of \$2,500. What was B's net profit? B's net sales?
14. Last month Retailer C had an opening inventory at cost of \$2,200, closing inventory at cost of \$3,200, and cost of goods sold of \$10,000. Find C's purchases at cost.
15. A wholesaler is planning his operations for the coming year. After analyzing company records, he estimates during the coming year expenses will amount to \$19,900 and gross margin will be \$27,000. The wholesaler says he will be satisfied with a net profit of 4 per cent on sales. What sales volume goal should he set for the coming year?
16. On the basis of the following operating data, compute stock-turn rates (a) using cost figures, and (b) using selling price figures:

Net Sales	\$19,500
Markdowns	250
Allowances to Customers	250
Cost of Goods Sold	10,000
Opening Inventory at Cost	3,000
Opening Inventory at Selling Price	6,000
Closing Inventory at Cost	2,000
Closing Inventory at Selling Price	4,000

How do you explain the difference between the two stock-turn rates?

17. A retailer currently has monthly sales of \$100,000 and an average inventory of \$25,000 at selling price. He wants to increase his stockturn rate from 4 to  $4\frac{1}{2}$ . Explain at least two different alternatives he might consider in working toward this target stockturn rate of  $4\frac{1}{2}$ .
18. A certain manufacturer makes and markets a single product. His total fixed costs amount to \$100,000 annually, and variable costs are 57 cents per unit of product. The manufacturer sells his product to wholesalers at a price of \$9.00 per dozen. Compute: (a) the manufacturer's break-even point in dollars, and (b) the manufacturer's break-even point in units of product.
19. The J. Quill Company is considering launching an advertising campaign to introduce its product in a new territory.

The product is sold to dealers at a price of \$1.50 each, and the marketing manager calculates the unit contribution to fixed costs at 40 cents. If the proposed advertising campaign in the new territory is budgeted at \$20,000, how many units of the product will the company have to sell in the new area in order to just break even? How many units will have to be sold in the new territory in order to add a total of \$5,000 as a contribution to fixed costs?

20. In analyzing the operations of a supermarket, an investigator obtained the following data:

<i>Department</i>	<i>% of Store Sales</i>	<i>% of Store Gross Margin</i>	<i>Sales per Square Foot</i>	<i>Gross Margin per Square Foot</i>
Grocery	38.65%	31.04%	\$1.66	\$0.24
Meat	34.39	38.49	3.00	.61
Produce	10.71	15.78	1.70	.46
Dairy	9.10	6.92	4.47	.62
Bakery	4.97	5.47	1.33	.27
Frozen Food	2.18	2.30	1.20	.23
	100.00%	100.00%		

- a. Suppose you are the owner of this supermarket, how might you go about analyzing the above data?
  - b. How might various suppliers of supermarkets make use of this information?
  - c. What is the significance of the sales per square foot figure? The gross margin per square foot figure?
21. \* The Cranston Company manufactured industrial products which it sold to mill supply houses through five salesmen, each serving a separate territory. Total net sales in a given year amounted to \$1,193,000. Compensation and expenses of the salesmen came to \$99,000. This yielded a direct selling expense ratio of 8.3 per cent. While management found this information interesting, it desired further details and, as a result, the following two tables were prepared. Scrutinize the data in these two tables and make whatever recommendations to management you think might be appropriate.

\* Adapted from C. H. Sevin, *Analyzing Your Cost of Marketing* (Washington, D. C.: Small Business Administration, June 1957).



*Table 1: Comparative Performance of Salesmen*

<i>Sales Area</i>	<i>Total Calls</i>	<i>Total Orders</i>	<i>Sale/Call Ratio</i>	<i>Sales by Salesman</i>	<i>Av. Salesman Order</i>	<i>Total Customers</i>
A	1,900	1,140	60.0%	\$ 456,000	\$400	195
B	1,500	1,000	66.7	360,000	360	160
C	1,400	700	50.0	280,000	400	140
D	1,030	279	27.1	66,000	239	60
E	820	165	20.1	31,000	187	50
	<u>6,650</u>	<u>3,784</u>	<u>44.8%</u>	<u>\$1,193,000</u>	<u>\$317</u>	<u>605</u>

*Table 2: Comparative Cost of Salesmen*

<i>Sales Area</i>	<i>Annual Compensation</i>	<i>Expense Payments</i>	<i>Total Salesman Cost</i>	<i>Sales Produced</i>	<i>Cost/Sales Ratio</i>
A	\$11,400	\$ 5,600	\$17,000	\$ 456,000	3.7%
B	10,800	7,200	18,000	360,000	5.0
C	10,200	5,800	16,000	280,000	5.7
D	9,600	12,400	22,000	66,000	33.3
E	10,000	16,000	26,000	31,000	83.8
	<u>\$52,000</u>	<u>\$47,000</u>	<u>\$99,000</u>	<u>\$1,193,000</u>	<u>8.3%</u>

# MARKETING

## RESEARCH

# 13

Marketing research, as defined by the American Marketing Association, consists of "the systematic gathering, recording, and analyzing of data about problems relating to the marketing of goods and services."<sup>1</sup> The key word in this or any definition of marketing research is *data*. All that the A.M.A. definition specifies about data, however, is that it should *relate* to marketing problems and, at least for our purposes, that is not being specific enough. The real trouble with this definition is that it describes a *means* but does not mention the desired *end*.

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<sup>1</sup> Committee on Definitions, *Marketing Definitions* (Chicago: American Marketing Association, 1960), pp. 16-17.

We believe, in other words, that this definition needs amending to include the notion that marketing research should result in information which is useful in making marketing decisions. Let us modify the A.M.A. definition, then, as follows: *Marketing research is the systematic gathering, recording, and analyzing of data about marketing problems toward the end of providing information useful in marketing decision-making.*

Putting information to use in marketing decision-making generally requires the tapping of both internal and external sources of data. The internal studies, as we saw in Chapter 12 ("Operating Data for Marketing Decisions"), focus on resources and activities within the company; the external studies, as we shall see in this chapter, are concerned with the relations of the firm to its environment, and particularly to its markets. However, as we brought out in the preceding chapter, the marketing decision-maker must consider internal data in the light of information from external sources. The converse of this is also true: information revealed by external studies must be considered in relation to data obtained from internal sources. Internal and external marketing studies, therefore, are necessary complements of each other; both are essential elements in the informational groundwork for marketing decision-making. In fact, as Wroe Alderson so aptly puts it, "the art of management might be said to consist precisely of taking account simultaneously of the inner workings of the firm and its interaction with external forces."<sup>2</sup> In this chapter, then, the emphasis will be on external marketing studies. But we should not lose sight of the fact that the results of such studies are useful for marketing decision-making only when they are considered along with relevant internal data.

#### THE EMERGING ROLE OF MARKETING RESEARCH

Marketing research as a formally-organized information gathering and analyzing unit is still a relative newcomer to American industry—less than a half century old. But marketers have probably always carried on a certain amount of "do-it-yourself" research. Indeed, even today there are small businesses in such close touch with their markets that their executives can obtain most of the information they need for marketing decision-making through first-hand contacts with final users of their products. However, with the rise of mass production and mass marketing, growing numbers of marketing executives have become more and more remote from their companies' final markets. Not only is there geographical remoteness, which comes about with company growth built on cultivation of distant markets, but also remoteness in the sense that many middlemen have been interposed in distribution channels. It is

<sup>2</sup> W. Alderson, "Marketing and Management Decision," *Cost and Profit Outlook*, January 1960, p. 3.

generally no longer possible, especially in a growing or already large company, for marketing decision-makers to communicate directly with final users—e.g., to listen personally to their complaints and suggestions.

With the geographical spread of distribution and the lengthening of distribution channels, increasing numbers of marketers have had to find other ways of getting information on their markets for use in decision-making. Since the late 1920's, more and more companies have been responding to this need by setting up specialized marketing research units and giving them formal organizational recognition. Even today, however, probably fewer than 50 per cent of all U.S. firms have formal marketing research departments.

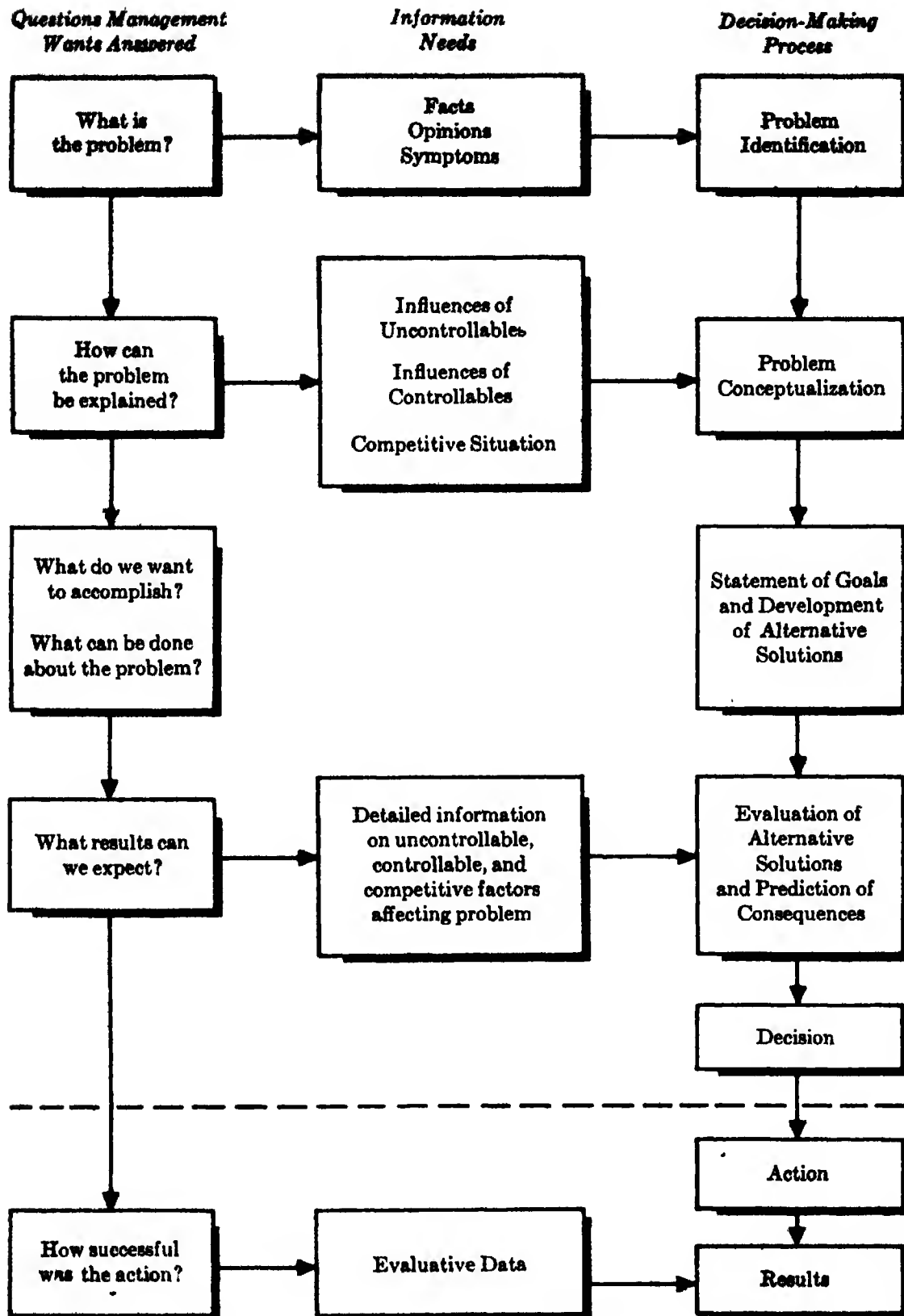
In the firms that do have marketing research departments, many different analytical techniques and research methods have been developed and are continually being refined. No doubt this represents progress, but the unfortunate, and all too prevalent, tendency has been to emphasize the tools and methods of research and to lose sight of their uses. In other words, business organizations have too often forgotten that the purpose of marketing research, as of any research, is to provide decision-makers with information needed for making better decisions. Research methodology, ways of thinking, theories, knowledge, and skills change with time as progress is made. But one thing that remains constant is the concept of careful search to generate a flow of ideas and information which will help executives make better decisions.<sup>3</sup>

A logical place to start, then, in understanding the evolving role of marketing research is with the decision-making process itself. Figure 13.1 shows how marketing research, through systematic gathering and analysis of information, should assist in answering questions that must be resolved during the decision-making process. Starting with the problem identification stage, marketing research helps marketing management in gathering facts, opinions, and symptoms of the problem. The problem identification stage phases naturally into the problem conceptualization stage, where marketing research, through gathering and analyzing information on the influences of uncontrollables and controllables and the competitive situation, helps management explain the problem. At this stage of decision-making, marketing research analyzes data drawn, of course, from both internal and external sources. Marketing researchers customarily refer to this aspect of their work as "preliminary exploration."

Marketing management, at the next stage, seeks to answer the questions "what do we want to accomplish" and "what can be done about the problem." As shown in Figure 13.1, these are questions management

<sup>3</sup> J. W. Newman, "Put Research into Marketing Decisions," *Harvard Business Review*, Vol. 40, No. 2 (March-April 1962), p. 106.

**Figure 13.1**



Sources: Adapted from R. A. Hammond, "Making OR [Operations Research] Effective for Management," *Business Horizons*, Vol. 5, No. 1 (Spring 1962), p. 81; and J. W. Newman, *Motivation Research and Marketing Management* (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1957), pp. 395-397.

pretty well has to answer for itself, but even here marketing research may make a contribution. It can help, for instance, in the creative thinking whereby alternative solutions to the problem are developed. Before marketing research can make this particular contribution, however, marketing management must make clear what it wants to accomplish. Formulating the statement of goals, in other words, is the responsibility of marketing management.

Next comes the evaluation of alternative solutions and the prediction of their consequences in terms of relative contributions to achievement of the goals set by management. Answering management's question "what results can we expect" often requires that marketing research gather and analyze additional and detailed information on the factors affecting the problem—the uncontrollables, controllables, and the competitive situation. These pieces of additional evidence may be gathered through employment of various research methods and techniques—e.g., consumer surveys, test market studies, and motivation research projects.

After considering all this information (tempering it with previous experience, judgment, and imagination) marketing management reaches its decision and takes whatever actions are required to carry out the decision. Later, as management wonders "how successful was the action," marketing research may again be called on to provide the necessary evaluative data.

#### ***Common Organizational Problems in Using Marketing Research***

All too many managements do not see the relation of marketing research to marketing decision-making in the perspective outlined above. Too often they look upon the marketing research department as a "job shop"—a place to turn over investigative tasks that marketing management cannot tackle personally. Research departments in such companies tend to develop into organizational units preoccupied with routine, short-range operating problems.<sup>4</sup> Furthermore, organizational procedure in many companies has left the initiation of requests for research up to executives in marketing management. Not only do these executives tend to hesitate in initiating such requests, they are frequently unable to identify their problems clearly enough to ask for the help they need.<sup>5</sup> Marketing research departments, for their part, have far too often been headed by people overly fascinated with the "tool kits of research" and only mildly concerned with using these tools to aid marketing management with its decision-making. Typically, too, heads of marketing research departments have been given far lower organizational status than have marketing management executives, resulting in situations where persons with low status are supposed to guide (rather than merely

<sup>4</sup> *Ibid.*, p. 110.

<sup>5</sup> *Ibid.*, p. 109.

advise) executives with much higher status. This is definitely not conducive to capitalizing fully on the great potentials of marketing research.<sup>6</sup>

### *Improving Effectiveness of Marketing Research*

Marketing research departments of the future should, we think, be headed by people who understand the true role of marketing research—that of providing marketing executives with the information they need to make better decisions. Once this role is fully understood, it will become a regular practice for marketing research departments to undertake long-range programs designed to gather and analyze information in advance of the requests of decision-makers.<sup>7</sup> It should, in fact, be rather common practice, by say the 1970's or 1980's, for the marketing research department to conduct many of its studies on a continuous basis, forwarding the resulting information and analyses to decision-making executives. Marketing management, of course, will still originate some requests for certain studies but, with the emergence of what Mr. F. A. Lindsay, president of Itek Corporation, calls the "Age of Information," there are no really good reasons why marketing research should not anticipate most informational needs.<sup>8</sup> Hence, marketing research departments in the future are likely to carry on long-range research programs as well as short-run projects. With this development, there should also come an upgrading of the marketing research department's place in the organizational structure, enabling its director to enjoy not only greater status but greater influence in the network of marketing decision-makers.<sup>9</sup> These important changes, of course, will come about only if marketing management *and* marketing research people recognize the great benefits that are likely to result, and work actively together to see that they do.<sup>10</sup>

<sup>6</sup> For a highly entertaining account of how a similar organizational problem might be analyzed differently by various experts, see: E. H. Porter, "The Parable of the Spindle," *Harvard Business Review*, Vol. 40, No. 3 (May-June 1962), pp. 58-66.

<sup>7</sup> On this point, see: A. E. Pearson, "An Approach to Successful Marketing Planning," *Business Horizons*, Vol. 2, No. 4 (Winter 1959), p. 80.

<sup>8</sup> For a revealing analysis of problems facing the information age marketing manager, see: F. A. Lindsay, "Marshal Your Marketing Information," *Business Horizons*, Vol. 5, No. 2 (Summer 1962), pp. 53-60.

<sup>9</sup> For a related line of reasoning leading to much the same prediction, see: H. J. Leavitt and T. L. Whisler, "Management in the 1980's," *Harvard Business Review*, Vol. 36, No. 6 (November-December 1958), pp. 41-48.

<sup>10</sup> "Oddly enough, the rapid advance of technology, the abundance of new computers and new techniques, and the tremendous changes in the capacity and potential of new computers, all have been so intriguing that planning for their use has lagged . . . [The] ability of the average company to utilize the new computers and techniques falls far short of the potential the computer has to process the information necessary to operate the system." For suggestions on how to deal with this problem, see: M. K. Evans and L. R. Hague, "Master Plan for Information Systems," *Harvard Business Review*, Vol. 40, No. 1 (January-February 1962), pp. 92-103.

**SCOPE OF MARKETING RESEARCH**

In analyzing the scope of marketing research operations in 195 companies, one careful student found that 39 different major types of marketing research were being performed.<sup>11</sup> These 39 types can be sorted into four major categories: (1) studies on influences of uncontrollables, (2) studies on the competitive situation, (3) studies on influences of controllables, and (4) studies on market measurement and planning.<sup>12</sup> The different types of marketing research are grouped into these four major categories in the listing below. The figures in parentheses refer to the proportion of the 195 companies which were performing the specific type of marketing research at the time of the study.

**A. Studies on Influences of Uncontrollables**

1. General business or economic forecasting (concerned primarily with general business climate rather than a single industry) (73%)
2. Studies of economic factors affecting sales volume and opportunities (examples: level of consumer credit, consumer buying intentions, business expansion plans) (72%)
3. Studies of shifts in the nature of the market (examples: sectional changes, age-distribution trends, income-distribution trends) (70%)
4. Motivational research (examples: studies of consumer and customer buying motivations) (51%)

**B. Studies on Competitive Situation**

5. Studies on competitive position of company products (91%)
6. Comparative studies of competitive products (79%)
7. Evaluation of new competitive products or competitive new product developments (79%)
8. Studies of price policies, discount structures, etc. of competitors (75%)
9. Studies of advertising and selling practices of competitors (69%)

**C. Studies on Influences of Controllables**

10. Determination of consumer or customer acceptance of proposed new products or services (82%)
11. Establishment or revision of sales territories (80%)
12. Evaluation of existing sales methods (75%)
13. Analysis of salesmen's activities (74%)
14. Studies of advertising effectiveness (73%)
15. Determining present uses or applications of existing products (72%)
16. Price studies (71%)
17. Appraisals of proposed changes in sales methods (71%)

<sup>11</sup> R. D. Crisp, *Marketing Research Organization and Operation* (New York: American Management Association, Inc., 1958), Research Study No. 35, p. 40.

<sup>12</sup> Crisp (*Ibid.*) did not actually utilize the four major categories as stated above. His report, however, does classify the 39 types into four alternative classifications: (1) research on products and services, (2) research on markets, (3) research on sales methods and policies, and (4) research on advertising.



18. Evaluations of advantages or limitations of proposed new products or services (70%)
19. Measurement of the effectiveness of individual salesmen (70%)
20. Studies of dissatisfaction with existing products or services among present or former consumers (69%)
21. Determining or exploring new uses or applications of existing products (68%)
22. Studies aimed at product simplification or at length or completeness of line of products (68%)
23. Studies of distribution costs (68%)
24. Setting sales quotas (68%)
25. Development of standards of sales performance (63%)
26. Studies of sales compensation—evaluation, review or revision (62%)
27. Selection of advertising media (62%)
28. Packaging research (design or physical characteristics) (60%)
29. Studies of the effectiveness of promotional devices (examples: "deals," "premiums," "coupons") (56%)

*D. Studies Focusing on Market Measurement and Planning*

30. Analysis of market size (size of market for specific products) (90%)
31. Estimation of demand for new or proposed new products (89%)
32. Sales forecasting for the industry or company (88%)
33. Analysis of the characteristics of the market for specific products (87%)
34. Analysis of territorial potentials or sales opportunities (87%)
35. Studies of trends in market size by products (86%)
36. Measurement of territorial variations in sales yield (73%)
37. Studies of the relative profitability of different markets (73%)
38. Market test or test-market operations on new or improved products (70%)
39. Studies of changes in the importance of different types of customers (67%)

The inclusion of 39 different types of studies in the above list should *not* lead us to conclude that all marketing research studies are single-purpose ones, or that each type is performed in isolation of others. No marketing research study should ever be conducted in such a way that it considers *only* the marketing factor it sets out to investigate. No marketing factor ever exists in a vacuum, for no matter what the subject of the investigation is, it has marketing significance only when analyzed in relation to other marketing factors. Any marketing research study, then, may emphasize a single factor but it cannot study that factor in complete isolation. A company doing research preliminary to introducing a new product, for example, is well-advised to undertake an *integrated* marketing research program involving not only studies of marketability but also studies of the probable strength of demand at various prices, analyses of sales and territorial potentials, the impact of competitors' products and activities, the selection of advertising media and other pro-

motional devices, and the influences of uncontrollables on proposed sales methods. The variety and number of individual studies which should be included in an integrated program of this kind depends both on the quantity and types of information marketing management thinks it needs, and on the amount of money management has available and is willing to allocate to the program.

#### *Studies of Influences of Uncontrollables*

Relatively few marketing research studies focus directly on the influences of uncontrollables. This could perhaps simply reflect the all-too-prevalent condition that no ranking executive specifically "requested" such studies, but it is more likely that most marketing decision-makers feel that they can obtain the needed information on uncontrollables in the course of their regular business reading. After all, published information is readily available on such uncontrollables as the level of consumer credit, business expansion plans, age- and income-distribution trends, and consumer buying intentions. Federal government publications such as the *Statistical Abstract of the United States*, the *County and City Data Book*, the *Survey of Current Business*, and the *Federal Reserve Bulletin*, are rich sources of quantitative data on the uncontrollables and, in addition, often provide analyses of trends in income distribution, population growth and shifts, and consumer instalment credit. The Office of Business Economics of the U.S. Department of Commerce gathers and publishes data on many factors including that on the national economic situation and outlook and the balance of international payments. The Department of Commerce also maintains 33 field offices which assist businessmen and others looking for specific types of information and, in addition, publishes the monthly *Distribution Data Guide*, which lists and reviews recent marketing publications, both governmental and private. Marketing decision-makers also get considerable information on the uncontrollables through their reading of such popular business publications as *Business Week*, *Forbes*, *Dun's Review and Modern Industry*, *The Wall Street Journal*, *Nation's Business*, *Sales Management*, and *Printers' Ink*.

Even though executives may get much information on the uncontrollables in the course of their regular business reading, seldom do they take the trouble (or have the time) to organize data gathered from numerous sources and to analyze the results in terms of their own company's marketing problems. The marketing research department, in contrast, when assigned the task of studying the uncontrollables, can routinely and expertly assemble and analyze marketing information—i.e., process it—putting it into perspective more useful to the decision-maker.

The motivation research studies, which delve into the complex psychological and sociological variables affecting buying behavior, are in a class by themselves. Why, as the above report shows, do so many companies not use motivation research? Part of the answer lies in the fact that doing and interpreting motivation research requires the services of trained specialists—psychologists and sociologists skilled in the research methods of their own fields. Few companies have such people on their payrolls, and the bulk of the motivation research that is done is handled by outside consultants. Then, too, motivation research is still a comparatively new field, and many executives are not only doubtful of its value but suspicious of many of its findings. As more of the mystery surrounding motivation research gets cleared away, we can expect that more and more companies will use it.

#### *Studies of Competitive Situation*

The American Management Association report referred to earlier shows that many companies give more emphasis to studies of the competitive position of their own products (type 5 in the list) than they do to studies of the nature and impact of competitive activities (type 6 through 9). Measuring the "share-of-the-market" which the company's product has would be an example of a type 5 study, whereas types 6 through 9 are illustrated by such studies as those appraising the marketing strengths of a competitor's products, evaluating the marketing effects of a competitor's product improvement, measuring the impact of a competitor's price change, and appraising the effects of a competitor's change in advertising policy. Probably the reason the type 5 study has been emphasized more than the others is that share-of-the-market information often can be readily obtained through outside research organizations, often on a "subscription" basis.<sup>13</sup> Other companies find it relatively easy to compute share-of-the-market percentages for their own products, especially if they have access to industry sales figures gathered and distributed by trade associations. Most companies could probably benefit greatly if they would do more "intelligence" type studies (types 6 through 9)

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<sup>13</sup> The A. C. Nielsen Company, for example, whose home office is in Chicago and which operates not only in the United States and Canada but in twelve other countries as well, provides a number of information services on marketing that are widely used by manufacturers. One of these services—the Nielsen Retail Index—provides continuous factual marketing data on foods, drugs, pharmaceuticals, toiletries, cosmetics, confectionary, tobacco, photographic, and other products. For the food industry, for example, the Nielsen organization provides its subscribers with reports on sales to consumers measured at the point of sale, facts on sales to consumers made by competitors' products, breakdowns of sales figures to consumers nationally or by the manufacturer's sales territories, and breakdowns of consumer sales figures by size and/or type of stores. All this information is reported separately for the subscriber's product and for each important competitor—and all work is repeated every two months so that trends are shown.

—studies specifically designed to delve into competitors' marketing practices and policies. Such intelligence is needed if management is to understand how competitors' actions affect the company's marketing situation. Only if such intelligence is available can a management do a really effective job in plotting marketing strategy and counterstrategy.

#### *Studies of Influences of Controllables*

Among the 195 companies surveyed, the widest variety of marketing research studies focused on the influence of controllables—sales methods, products, advertising, promotion, and price. This should not be too surprising since, by definition, controllables may be manipulated, and modern management seeks the decision-making guidance provided by studies of the controllables. In many companies, too, management requests studies of individual controllables in order to appraise the effectiveness of current policies and practices. This is the managerial motivation most often underlying studies made of the effectiveness of advertising and other promotional devices, individual salesmen, existing sales methods, and sales compensation plans. Formal studies of this sort often serve to draw management's attention to situations requiring changes in policies and practices. Although controllables can be manipulated without such studies, their manipulation can be made more effective if management is provided with the added insight gained from special studies.

#### *Studies Focusing on Market Measurement and Planning*

The listing of marketing research studies showed that those involving market measurements and sales forecasting (types 30 through 35) are highly popular. Marketing management attaches considerable importance to factual and quantitative data on present and future markets, and the high proportions of companies reported as conducting studies directed toward those informational goals reflect this importance. In fact, market-measurement-and-planning studies play such a significant role in modern marketing management that we devote the entire next chapter to them. Consequently, we will not discuss them further here.

### **PROBLEM IDENTIFICATION AND MARKETING RESEARCH**

Even though marketing management may have already identified the problem to be investigated, it must take great care to make the exact nature of the problem clear to the researcher. The marketing researcher, like the marketing decision-maker, considers problem identification the basic first step in his work. Only if he knows what problem management is trying to solve, can he do an effective job in planning and designing

a research project that will provide the needed information.<sup>14</sup> Only if he has the problem clearly in mind, can he be expected to lend intelligent direction to the resulting project—to steer it as directly as possible to predetermined informational goals (set by the nature of the problem itself) and to keep it from “getting off course” on the way to these goals.

A competent marketing researcher, therefore, will not accept a request for a specific type of study unless he is sure that the executive making it has some problem already “pinned down” and not until that executive has been able to communicate the nature of the problem clearly. If he is to do his job effectively, the researcher must also be briefed on the line of reasoning which led up to the request. He needs this briefing in order to avoid researching “surface” problems when there is some more basic problem; all too often, executives request studies which subsequently prove of little value simply because they have not probed far enough into the situation to find the basic problem. Seeing that sales are falling off, for example, a marketing manager may feel that something “has gone wrong with the advertising” and submit a request to marketing research for a study of advertising effectiveness. In one case just like this (known to the writers)—where a study of advertising effectiveness was requested—further probing by an alert researcher revealed that the sales decline traced directly to the effects of a recently inaugurated distribution policy which was slowing up deliveries to retailers who, in turn, were frequently out-of-stock. The researcher can perform a useful service, therefore, not only by lending assistance in the initial identification of problems, but in confirming (or casting doubt on) the identification of problems which the executive thinks he has already pinpointed.

#### **PRELIMINARY EXPLORATION AND THE “SITUATION ANALYSIS”**

In the course of identifying the problem, the marketing researcher begins his preliminary exploration of data sources which, he hopes, will help him to understand the problem. Because the specific problem is not yet identified, the researcher necessarily does a certain amount of groping as he seeks information which will help him clarify its nature. This characteristic groping makes the preliminary exploration phase of research an informal and, to a large extent, an unplanned investigation. Even so, this should not mean that most of the preliminary exploration effort is wasted effort. It should mean only that the researcher does not yet know exactly what information he is seeking, but that he has a feel for the general sorts of information wanted and he knows more or less where to find it. The greater the researcher’s skills as a diagnostician,

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<sup>14</sup> H. W. Boyd, Jr. and R. Westfall, *Marketing Research: Text and Cases* (Homewood, Ill.: Richard D. Irwin, 1956), p. 160.

the smaller the chances are that his preliminary exploration will involve excessive waste of time and effort. During this informal search, the researcher sizes up the nature and extent of available data and makes some tentative judgments concerning its probable future usefulness.

Once a problem situation has been identified, the researcher's task is to learn as much more about it as time will allow. He can never hope to become as intimately acquainted with *all* the possible problem situations that might come up as can the decision-making executives he serves, such as the marketing manager, sales-force manager, and advertising manager. Yet when information is required for decision on some specific marketing problem (for example, the size of next year's advertising budget), and the information (or at least important segments of it) must be gathered through marketing research, the researcher must learn all that he can about the problem situation before designing and conducting the research project itself. He must, in short, build an adequate background for his own thinking. Marketing researchers refer to this phase of preliminary exploration as the "situation analysis."

The preliminary exploration process, always crucial, is especially so when an outside firm is to handle the study as, for example, when a marketing research consultant is working under contract. The consultant not only has to learn all that he can about the problem situation but also must fill in the gaps in his knowledge of the problem "setting." He must, for instance, become acquainted with any company policies and operating practices that might affect the nature of the problem. To expedite assembly of pertinent data on the problem setting, consultants make considerable use of standard outlines, which provide logical frameworks for analysis of many, if not most, complex marketing problems.<sup>15</sup>

In performing a situation analysis, the researcher taps as many sources of readily available data as his time schedule will permit. He examines whatever company records (sales, financial, production, and others) there are that might shed some light on the problem. He skims trade and professional publications for reports on similar or related problems encountered and researched by other companies. And he looks over his own company's reports of previous investigations of similar problems.

He should reserve his most thorough and careful examination for reports of previous marketing research studies that may be on file. Through studying them, he may be able to decide which aspects of the problem can probably be investigated with the greatest resulting benefit. He

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<sup>15</sup> Such outlines contain numerous questions relating to specific aspects of a firm's situation with respect to the industry, the firm's position in the industry, the products, packaging, the markets, distribution, pricing and profits, promotional methods and policies, sales force activities, and so on. For a sample of an excellent standard outline of this kind, see: D. J. Luck, H. G. Wales, and D. A. Taylor, *Marketing Research*, 2nd ed. (Englewood Cliffs, N.J.: Prentice-Hall, 1961), pp. 63-64.

should look for and try to detect shortcomings of previous studies with a view toward planning the forthcoming research project along lines which will avoid these same shortcomings. And he should not overlook the possibility that previous studies may have already provided the information he now seeks or, perhaps, that they contain sufficient data to satisfy the decision-maker's immediate needs.

#### **PROJECT PLANNING FOR MARKETING RESEARCH**

Basically, a marketing research project is a *planned search for information*. Time spent in planning the project should not only reduce the time required to conduct the project but should also ultimately result in more reliable and meaningful information. When project planning has been neglected, marketing researchers move aimlessly from one possible source of information to the next, choose research methods and approaches at random, and have only the vaguest notions concerning the kinds of information they seek. The earmarks of project planning in marketing research, as elsewhere, are well-defined goals, an organized effort, and a step-by-step schedule—all aimed at uncovering, reporting, and analyzing as reliable and meaningful information as is possible to obtain in the available time.

Because no marketing problem is quite like any other, the research projects set up to investigate individual problems must themselves be individualized. There are no magic research formulas for *all* marketing problems (or even for any given class of marketing problems). But even though each marketing research project must be set up and planned individually, there are certain steps every project must include and each of these steps can be planned in advance.

Although every project must include these steps, each step in each project can be handled in quite unique ways.<sup>16</sup> In planning a marketing research project, the researcher has to decide what each step will consist of and on how it will be carried out. We call these decisions "project planning decisions." Such decisions are closely interrelated and, when they are interlaced in an embracing pattern, they constitute the project plan.

Planning any marketing research project involves making decisions on (1) research objectives, (2) specific information needed to achieve these objectives, (3) sources to tap in seeking the information, and (4)

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<sup>16</sup> "Market research techniques rarely are definitive. Usually, the magnitude of error to which they are exposed is not even measurable; also, practitioners of market research often disagree about the suitability of different techniques. These facts notwithstanding, the results achieved by carefully planned and executed market research provide a basis for decision that is more reliable than intuition or business experience." A. R. Oxenfeldt, "Scientific Marketing: Ideal and Ordeal," *Harvard Business Review*, Vol. 39, No. 2 (March-April 1961), p. 64.

research method(s) to employ in collecting the information. We will, in the following sections, give detailed analysis to each of these important decisions.

### *Deciding on Research Objectives*

Assuming that the marketing problem has been identified and the preliminary exploration finished, the first step in project planning is to decide on research objectives. The preliminary exploration should have left the researcher with some clear notions as to the purposes of any formal research project which might be set up. After the preliminary exploration yields a set of tentative conclusions (the desired outcome of the preliminary exploration) about the specific problem, the researcher goes ahead and designs a formal research project in order to test the validity of these conclusions. For example, in a study of how a company spends its advertising appropriation, the preliminary exploration might have caused the researcher to conclude tentatively that less money should be devoted to newspaper advertisements and more to television. In this case, then, the purpose of the research project could be to test two hypotheses:

1. The company should spend less money on newspaper advertising.
2. The company should spend more money on television commercials.

As just illustrated, the statement of research objectives should, whenever possible, be simply of a small number of hypotheses to test, or a small number of questions to be answered. The number must be kept small since it cannot be expected to produce both timely and reliable information for managerial decision, if the project is directed toward finding out too many things. If the project is set up to test too many hypotheses, one of two things tends to happen—either the research (performed thoroughly) requires an inordinate amount of time and money, or the study suffers from purely surface investigations of each hypothesis. In pruning the list of hypotheses which might be tested, the researcher must consider the value of testing each hypothesis by answering these two questions:

1. If we succeed in obtaining this information, of what use will it be to the decision-maker?
2. If this information is of possible usefulness to the decision-maker, is it useful enough to justify the cost of obtaining it?

Research costs money, and this serves as a built-in brake on the ambitiousness of the researcher in setting his research objectives. If just so much money is available, the scope of the project must be limited to obtaining that information most important to the decision-maker. Some researchers, unfortunately, tend to get so wrapped up in finding out



"everything there is to know about a problem" that marketing executives in assigning individual projects deliberately instruct such people "to spend no more than X dollars on this project." No competent marketing researcher likes to be bound by such restrictions, so they are well-advised to form the habit of "cutting each project down to size" before limiting instructions come down from superiors. The list of hypotheses for testing should be kept to a very small number of important ones, preferably to those so related that they can be jointly, and thus economically, researched.

#### ***Deciding on Information Needed***

The second key project planning decision is that of determining the specific information needed to achieve the research objectives. When these objectives have been clearly stated, the researcher proceeds to consider different types of information which, on first thought, seem to him to be pertinent to achieving the objectives. Further reflection is necessary, however, for he must be absolutely certain that each bit of specific information finally decided upon is relevant to achieving the research objectives. Suppose, for example, that the research project being planned has the objective of answering a South American businessman's question, "Should I open a self-service automatic laundry and dry cleaning establishment in Bogotá, Colombia?" What kinds of information are necessary to answer this question? The researcher would want, as a minimum, the following information:

1. Number of Bogotá residents who are potential users of this type of service
2. Number of residents able and willing to pay for the service at each of several proposed rates (i.e., prices)
3. Probable frequency and intensity of use of the service (How often and how much will different social and income classes use the service?)
4. Competing services and their comparative costs
5. Which laws and other regulations might affect the operations of a service establishment of this type? Will they facilitate or impede setting up the business?
6. Amount, kinds, and costs of persuasion (advertising, etc.) needed to convince Bogota residents that they ought to patronize the service

#### ***Deciding on Information Sources***

The next step in project planning is to identify the sources from which the different items of information are obtainable, and to select the sources

that will be used. For this purpose, it is convenient to classify information sources not as internal or external but rather as being either primary or secondary. A primary data source is one from which the desired items of information must be obtained directly as, for example, through questionnaires and interviews. Primary data sources, then, include consumers and buyers, middlemen, salesmen, trade association executives, and other businessmen. Secondary data sources are mostly published sources, such as the numerous government census publications and *Sales Management's Survey of Buying Power*; <sup>17</sup> although sometimes other kinds of secondary sources (e.g., company files of marketing research and other reports) contain the desired information. Secondary data sources, in other words, are repositories of items of information not gathered specifically to achieve the objectives of the research project being planned, but rather assembled for some other purpose or use. The characteristic that most distinguishes the primary source from the secondary source is that the former must be tapped directly (through use of research methods covered in the next section) to obtain the desired information, whereas the latter may have the data already on hand, either in published form (as in the government and business publications cited earlier) or on file (as in the case of company reports gathered for some other purpose).

The researcher should always look to the secondary sources first for, if the needed information is already available, the time and expense of gathering it from primary sources can be saved. The usual situation, however, is that some information can be obtained from secondary sources (e.g., statistics on population and income) but the more crucial data (e.g., the disposition of consumers to buy a given product under certain marketing conditions) have to be obtained from primary sources. In the Bogotá study on whether a self-service laundry should be opened, for example, census publications (a secondary source) should reveal the number of residents that are potential users, and published legal records (another secondary source) would tell which laws and regulations affect the operation of this type of service. But in order to obtain the other desired pieces of information, the researcher would have to work with primary sources (in this case, the potential consumers).

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<sup>17</sup> Already large, the quantity of published literature useful in marketing research is growing at an ever-increasing rate. With so many sources of secondary information available, the researcher often must feel that the haystack is growing faster than his ability to find the needle. Prompted by this situation, the American Management Association has recently provided its members with a guidelist for purposes of (1) furnishing leads to sources of information, and (2) classifying and indexing significant reports. See: American Management Association, *Guidelist for Marketing Research and Economic Forecasting*, Research Study No. 50 (New York: American Management Association, 1961).

**Deciding on Research Methods**

Research methods are used only in working with primary sources. If all the needed information is obtainable from secondary sources, then, no decision on research methods is required; but if, as is more likely, primary sources must be used a decision is required as to research methods. There are three main research methods—the survey, the experimental, and the observational. These are discussed below.

**SURVEY METHOD.** In the survey method, information is obtained from individual respondents, either through personal interviews or through the use of mail questionnaires and telephone interviews. Questionnaires (personally-administered, mailed, or telephoned) are used either to obtain specific responses to direct questions or to secure more general responses to “open end” questions. The direct type of question is designed to force the respondent to choose among a limited number of answers. Consider this example: “How do you feel about the styling of this new electric typewriter? Do you rate it as EXCELLENT \_\_\_\_, GOOD \_\_\_\_, FAIR \_\_\_\_, or POOR \_\_\_\_?” This question contrasts sharply with the “open end” question: “What do you think about the *styling* of this new electric typewriter?” Notice that this last question permits the respondent to come up with his own answer.

The survey method has three main uses. It may be used: (1) to gather facts from respondents, (2) to report their opinions, or (3) to probe the interpretations individuals give to various matters. The accuracy and reliability of the survey method is not the same in each of these applications. Generally, it is most accurate and reliable when used to gather factual data, less so when used to record opinions, and least so when used to gain insights into respondents’ interpretations.

In the *factual survey*, respondents are asked questions which are designed to elicit only factual responses. For example:

What brand of cigarettes do you smoke?

Where do you do most of your shopping for groceries?

Have you ever bought *Playboy* magazine at a newsstand?

How many people live at this address?

Presumably, the people who respond in a factual survey will be able to report facts. But, almost always, some respondents are unable to remember past events and actions. Others experience difficulty in making their answers specific enough as, for example, in answering the question “At which store do you do most of your shopping for groceries?” They may shop for groceries at several stores and simply be unable to name the one store where they do *most* of their shopping. Still other respondents (being

only human) try to impress the interviewer favorably by giving him the answer they think he wants; for example, a respondent, assuming the interviewer has some connection with *Playboy*, says "Why, yes, I bought *Playboy* just last week," when actually he only thumbed through a copy while waiting in the barber shop.

The *opinion survey* is designed to gather expressions of personal opinions, record evaluations of different things, or to report thinking on particular matters. Respondents often are unaware that they are supplying their opinions and believe, instead, that they are simply reporting "facts." This is the usual case, for instance, when housewives are asked such questions as "which local supermarket has the most courteous checkers?" Other questions typical of those in opinion surveys include:

Which of these designs do you like the most (e.g., asked when showing several different designs of dinner plates)?

Which pharmacy in your area does the best job of filling doctors' prescriptions?

What do you think about the future of the tourist industry in this state?

Errors also get into opinion surveys. Respondents in opinion surveys, as those in factual surveys, may give the answers they think that the interviewer wants, or be unable to provide specific answers to such questions as "Which pharmacy in your area does the best job of filling doctors' prescriptions?" Possibly several pharmacies do excellent jobs, and the respondent is unable to say which *one* does the *best job* so he answers "I don't know" when he really means "There are a number of excellent pharmacies in my area." Furthermore, respondents in opinion surveys may never have thought about the subjects of the questions until the interviewer raises the specific questions, and this may cause them to give quick responses, often different from those they would give had they time to consider the questions.

In the *interpretative survey*, the respondent acts as an interpreter as well as a reporter. Interpretative data is gathered by way of such questions as "Why do you use *Brand X* spray deodorant?" and "What about the new *Thunderbird* appeals to you most?" Answers to such questions are subject to all the limitations of answers to factual and opinion surveys and, in addition, they reflect the inability of many respondents to consciously interpret their own feelings, motives, and attitudes. Even if a person is capable of accurately knowing such things, the personal nature of the required answer often causes him not to report his feelings, motives, and attitudes the way they really are. Indeed, this particular source of error in interpretative surveys is frequently cited as a reason for the rising interest in motivation research, which is aimed not at answering "why" questions directly but indirectly through such techniques as depth

interviewing and sentence completion tests.<sup>18</sup> And, as is true in all kinds of surveys respondents in opinion surveys may come up with the answers easiest to give hoping to rid themselves of the interviewer in the shortest possible time. It is interesting to note that motivation researchers sometimes seek to probe the unconscious through asking respondents to "answer these questions with the first thing that pops into your mind." While such quick responses comprise the basic data for analysis in certain motivation research studies, quick responses volunteered in an opinion survey are all too often simply erroneous opinions given instead of opinions that would take more time to express.

**EXPERIMENTAL METHOD.** Patterned after the experimental method of scientific research, the experimental method as used in marketing research involves carrying out a small-scale trial solution to a problem while, at the same time, attempting to control all factors relevant to the problem except the one being studied. For example, an advertiser may run two versions of a proposed advertisement (Ad A and Ad B) in a city newspaper with half of the copies of the issue carrying Ad A and the other half Ad B, and might then arrange for follow-up interviews with the two groups of readers. This experiment, called a "split-run" test, might well have the purpose of determining the advertisement with the most impact on readers which, after being found to have the most impact in one market area, might then be placed in newspapers in other markets, or in national advertising media.

The main assumption in the experimental method is that the test conditions are essentially the same as those that will be encountered later when conclusions derived from the experiment are applied to a broader marketing area. Of course, test conditions are never quite the same as parallel conditions in the broader market area. Nevertheless, a well-designed experiment, even though it cannot replicate total market conditions, may provide valuable guidance and information for marketing decision-making. Scott Paper Company, for example, ever since it introduced paper towels to the consumer market in the early 1930's, has so carefully market-tested every new product that it claims none has ever failed when put into national distribution. Scott's policy is to study the market, conduct consumer interviews, study likes and dislikes, give the product a tentative name, and then to conduct a market testing experiment. After analyzing the results of such experiments, management may decide to change such product features as the name, size, shape, or color, but if changes are made

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<sup>18</sup> "No psychologist believes it is possible to really get at motives by simply asking people why they do something. The human being is so complex, and so much of our behavior is governed by emotions and quirks of personality that we just don't know the real underlying causes of so many actions." *Automobiles—What They Mean to Americans*, A Study for The Chicago Tribune by Social Research, Inc., 1954, p. 6.

which have important marketing implications (such as in the proposed retail price), further market testing experimentation is ordered.<sup>19</sup> The purposes of market testing, a widely-used form of experimentation in marketing research, are neatly summed up by Harvard Professor Ernest F. Enright, who says: <sup>20</sup>

Market testing is undertaken to reduce the risks faced by executives planning national distribution for their new products by providing them with different measures of how well their plans succeed on a small scale, by pointing up those areas in which their plans are inadequate, by providing an opportunity for any unforeseen problems to crop up, and by providing some of the time needed to make adjustments before the far greater risks of large-scale marketing are assumed by management.

There are really no "pat" designs for experiments. Each experiment has to be so designed that it will reveal the desired information as directly and quickly as possible. Alfred Politz, a marketing research consultant, illustrates this point by relating the story of the medieval king who faced a problem in experimental design. The king had ten manufacturers who minted his silver coins. Each coin was supposed to weigh 16 grams, but eventually it was discovered that some manufacturer was minting coins weighing only 15 grams. No one knew which manufacturer was the guilty party, so the king called a meeting and had each of the ten submit a sample of 10 of the coins he had minted. A spring scale was available but there was one difficulty (somewhat unusual in this instance, but wholly typical of the quandary marketing research often finds itself in): it was impossible to make more than a single weighing. The resourceful king, however, designed an experiment whereby he could determine which manufacturer was producing the underweight coins. How did he do it? He simply took a different number of each manufacturer's coins—one to ten—and the number of grams by which the total weight was short immediately identified the guilty party.<sup>21</sup>

**OBSERVATIONAL METHOD.** Here, marketing research data is gathered not through direct questioning of respondents, but rather by observing and recording their actions in a marketing situation. So, for example, in studying the impact of a department store's mass display of shelving paper, observers were unobtrusively stationed and instructed to record the total number of people passing by the display, the number stopping at the

<sup>19</sup> "Marketing: Secret Ingredients," *Forbes*, November 15, 1962, p. 43.

<sup>20</sup> E. J. Enright, "Market Testing," *Harvard Business Review*, Vol. 36, No. 5 (September-October 1958), p. 73.

<sup>21</sup> So, for example, if the total weight on the scale had been two grams short, the king would have immediately identified the manufacturer from whom he had taken two coins as the guilty party. See: A. Politz, "Science and Truth in Marketing Research," *Harvard Business Review*, Vol. 35, No. 1 (January-February 1957), p. 126.

display, the number who picked up and examined the product, and the number who made purchases. In another observational study, whose purpose was to determine which types of consumers bought what brands of home remedies, researchers secured permission from consumers to inventory the contents of household medicine cabinets. In a third observational study, researchers posing as customers used concealed tape recorders as part of a project which had the purpose of evaluating the selling techniques used by sales people in florist shops.

The main advantage of the observational method is that it records respondents' expressed actions and behavior patterns, thus avoiding errors which trace to "asking" (as in the survey) rather than "observing" what respondents actually do (as in the display example above) or have done (as in the medicine cabinet example). Its principal shortcoming is that its design does not provide for the detection of buying motives and other psychological factors since, in its pure form at least, the observational method involves simply watching or listening or both with no attempt being made to probe for the reasons lying behind actions and behavior patterns.

**CHOOSING THE RESEARCH METHOD.** In many problem situations, the researcher is confronted with the fact that two, or even all three, research methods could be used alternatively to obtain the needed information. The management of a shopping center, for example, might want to determine the extent of the area from which the center draws trade. In obtaining this information, one research approach could be to interview shoppers (the survey method). Another approach could involve recording (the observation method) license numbers of cars in the parking lot and checking license holders' addresses at the state motor vehicle bureau. In situations like this, the researcher must evaluate the different methods relative to the proposed research project and select the most appropriate method or, somewhat more rarely, combination of methods. Besides considering the nature of the problem, the researcher in making this choice should compare alternative methods according to costs, probable quality of data obtainable, time requirements, and personnel available for the study.

#### **GATHERING PRIMARY DATA THROUGH SAMPLING**

In gathering data from primary sources of information (i.e., from consumers, buyers, middlemen, and other classes of respondents) most marketing research projects make use of sampling. In order to clarify the place of sampling in marketing research, let us consider the hypothetical case of a manufacturer of men's shoes who must find out certain things in order to make certain decisions. For one thing, he would like to know



the distribution of foot sizes among the population (i.e., all men),<sup>22</sup> in order to balance his production in proportion to this distribution. One scheme for obtaining this information would involve measuring the foot size of every man in the population (i.e., taking a census of foot size). The manufacturer might also want to know men's preferences for different shoe styles and colors; again, he could conduct interviews with the entire population of men, determine their preferences, finally obtaining the information he needs to draft his production schedule.

There is, however, a much quicker and less costly way for the manufacturer to obtain the wanted information—through interviewing a representative group or “sample” of men. A sample is, by definition, only a portion of the population from which it is drawn; therefore, studying the characteristics and attitudes of the members of a sample, rather than of all members of the population, not only makes possible completion of the study in less time but results in lower costs of investigation. In fact limitations of time and money are the main reasons why marketing research usually investigates samples and not whole populations. “But,” you might ask, “isn't the information obtained from samples less accurate?” That depends, as we will see shortly, both on the method used in selecting the sample and on its size.

But before we go on to consider some important details of sampling, we must mention that it is possible for data obtained through sampling to contain fewer errors than data gathered through a complete census of the relevant population. For instance, when the size of the population is very large and providing scientific sample selection methods are used, there is a strong possibility that sampling will result in fewer errors. The possibility is even stronger when, as is usually true in marketing research, the funds available for the study are strictly limited. With only limited funds, making a census means that expenditures must be spread “thin”; but, in contrast, restricting the size of the field operation (through sampling) makes larger relative amounts available both for better control of data-collection processes and for the employment of high-caliber interviewing and other research personnel.<sup>23</sup>

Marketing research makes extensive use of sampling and, since research results are important ingredients for decision-making, marketing managers should know enough about sampling to allow them to evaluate the

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<sup>22</sup> Two of the most basic concepts in statistics are those of a *sample* and a *population*. “A sample is often referred to as ‘the data’ or ‘the observations’: numbers that have been observed. The population . . . is the totality of all possible observations of the same kind.” See: W. A. Wallis and H. V. Roberts, *Statistics: A New Approach* (Glencoe, Ill.: The Free Press, 1956), p. 101.

<sup>23</sup> D. J. Luck, H. G. Wales, and D. A. Taylor, *Marketing Research*, 2nd ed. (Englewood Cliffs, N.J.: Prentice-Hall, 1961), p. 178.



data they use. More specifically, they should know the inherent advantages and limitations of samples selected by different methods, and they should understand how sample size affects the amount of error present in research results. But here we must insert a word of caution: management certainly wants to avoid basing decisions on data full of errors, but it wants just as strongly to avoid demanding such error-free data that inordinate amounts of time and money are spent on the study. Greater expense and longer periods of investigation, in other words, are the prices of reductions in errors in marketing research. If, for management's purpose, accuracy within 10 per cent of the true picture is sufficient, aiming for accuracy that is within 5 per cent is wasteful both of research time and money.

### *Classes of Samples*

All of the samples used in marketing research fall into one of two classes: probability and non-probability. The fundamental distinction between these two classes lies in the way items are selected for inclusion in the resulting samples. Probability samples result from a process of random selection whereby each member of a population has a *known* chance of being selected for the sample. Non-probability samples result from a process in which considerable judgment (and, therefore, bias) enters into the selection of the members of a population which are included in the sample. Of course, judgment is also involved in the use of probability samples (in deciding, for instance, on a particular design of probability sample), but the actual selection of the individual items for inclusion is made solely through a probability mechanism as, for example, through a table of random numbers (which eliminates the human bias that would otherwise enter into the selection).<sup>24</sup> This difference between the two classes of samples, as to the extent to which judgment enters into the selection of the sample, may be illustrated as follows: In a "quota" sample, one type of non-probability sample, interviewers may be given quotas specifying that they are to select for interviewing a certain number of people who possess given characteristics; one such quota, for example, might be to "interview 20 women in the 35 to 45 age bracket, half of whom have full- or part-time jobs and half of whom are not employed outside the home." If the same study were to be made using a probability sample, the probability mechanism itself would be relied on to select representative proportions of people with the given characteristics, and the interviewer would play no part whatever in the actual selection of respondents. We will examine the relative merits of probability and non-probability samples

<sup>24</sup> J. Neter and W. Wasserman, *Fundamental Statistics for Business and Economics*, 2nd ed. (Boston: Allyn and Bacon, 1961), p. 439.

more fully later on; but, in order to make that discussion more meaningful, it is necessary first to consider the nature of sampling and non-sampling errors.

### Errors

We implied previously that both samples and censuses are apt to contain errors. There are, in fact, two kinds of errors—non-sampling and sampling. Samples contain both kinds of errors, whereas complete censuses contain only non-sampling errors. This, however, does not mean that census results are necessarily any more error-free than sample results. It only means that there is one kind of error in a census and two kinds in a sample.

**NON-SAMPLING ERROR.** Non-sampling errors occur both in studies which use samples and in those which involve complete censuses. Such errors are nothing more than the accidental (or deliberate) mistakes or errors that can happen during any of the stages of data collection, recording, and enumeration. Here are some examples of non-sampling errors: a field worker checks off a wrong answer; a respondent misinterprets a question; an interviewer misinterprets an answer; a field worker selects a wrong respondent; a field worker falsifies an interview; a clerk tabulates some data incorrectly; an interviewer biases respondents' answers by the way he asks questions; and a poorly-designed question elicits erroneous responses. In short, non-sampling errors are blunders and they occur both in complete censuses and in samples. Non-sampling errors cannot be measured (as can sampling errors) and taken into account in evaluating study results. Thoroughness in project planning and careful control over all phases of the subsequent study are the only ways that non-sampling errors can be minimized.

**SAMPLING ERROR.** A standard work on sampling principles says that:<sup>25</sup>

... in referring to *sampling error* or the *precision* of a sample result, we are referring to how closely we can reproduce from a sample the results which would be obtained if we should take a complete count or a census, using the same methods of measurement, questionnaire, interview procedure, type of enumerator, supervision, etc.

In other words, the measurements produced by samples (statisticians refer to these measurements as "parameters") are really *estimates* of the true statistic. And the measurements produced by censuses are also only estimates of the true statistic (non-sampling errors make them so). Statisticians, in evaluating a sample, use the term "accuracy" to refer to the difference between a sample result and the true statistic, and the term

<sup>25</sup> M. H. Hansen, W. H. Hurwitz, and W. G. Madow, *Sample Survey Methods and Theory* (New York: John Wiley and Sons, 1953), Vol. 1, p. 10.

"precision" to refer to the difference between a sample result and the result of a complete count.<sup>26</sup> Marketing researchers are concerned with both accuracy and precision—with accuracy throughout the project and with precision because it is statistically measurable<sup>27</sup> (but precision is only so measurable if the sample is selected by probability methods<sup>28</sup>) Sampling error (i.e., lack of precision) cannot be avoided, but when probability sample selection methods are used, it can be measured and controlled. The measure of sampling error is known technically as the "standard error of the sampling estimate," and is defined as follows:<sup>29</sup> A measure of the variability inherent in a sample value, due only to the sampling process (sampling error), [it] may be computed for almost any mathematically determined value obtained from a probability sample. Measures of sampling variability (i.e., standard error measures), then, can be computed for such mathematical values as arithmetic means and percentages when they are derived from probability sample results.<sup>30</sup> Since it isn't essential to our discussion to know how to calculate these measures of sampling variability, and since nearly every standard textbook in marketing re-

<sup>26</sup> "The words 'accuracy' and 'precision' are often used rather loosely and interchangeably, but there is a very important difference between the two concepts. *Accuracy* means freedom from error. *Precision* refers to the reproducibility of sample results; if many samples of the same size were taken from the same population by the same methods, the consistency among the results obtained from these various samples indicates the precision of the particular result based on samples of this type." T. T. Seimon, R. Cohen, S. B. Richmond, and J. S. Stock. "Sampling in Marketing Research," *The Journal of Marketing*, Vol. 23, No. 3 (January 1959), p. 269.

<sup>27</sup> The statistical "sampling error" of probability sample results is a measure of precision and not of accuracy. It is virtually impossible to measure the accuracy of sample results, either for probability samples or for non-probability samples.

<sup>28</sup> In at least the strictest application of the statistical techniques used for computing sampling error (i.e., for measuring lack of precision), these techniques apply only in the case of probability samples. This is because the mathematical foundation of the formulas used for measuring sampling error assume random (i.e., probability) selection of sample members which, of course, is not present in non-probability samples. Nevertheless, some marketing researchers do apply the formulas for sampling error to non-probability samples; for the rationale behind this application, see: R. D. Crisp, *Marketing Research* (New York: McGraw-Hill, 1957), pp. 277-278.

<sup>29</sup> Luck, Wales, and Taylor, *op. cit.*, p. 192.

<sup>30</sup> The formulas for computing these two measures are:

$$1. \text{ Standard Error of the Mean} = \frac{\text{Standard Deviation of the Parameter}}{\sqrt{\text{Sample Size}}}$$

$$2. \text{ Standard Error of a \%} = \sqrt{\frac{p \cdot q}{\text{Sample Size}}}$$

Where:  $p$  is the % of occurrence of a characteristic being studied

and:  $q$  is 100% -  $p$  (i.e., the % of non-occurrence of the same characteristic).

Each of these standard-error formulas can be transposed and used to calculate required sample sizes.

search explains the rather intricate calculations in detail, we need not go into them here.<sup>31</sup> It will be sufficient if you just keep in mind the fact that it is possible to calculate the amount of sampling error present in probability samples. This knowledge will help you to understand the discussion of sample size in the following section.

### Sample Size

Any executive who is in a position to approve expenditures for marketing research or who uses its results for decision-making should be familiar with the basic considerations affecting sample size. Common sense tells us, of course, that the larger a sample is the greater the chances are that research results will be reliable. However, the particular sampling method used (i.e., whether it is based on probability or non-probability selection) directly affects the significance of sample size as an indicator of reliability in research results and, as we noted a few pages back, research results obtained through sampling also contain non-sampling as well as sampling errors. Regardless of whether we have a probability or a non-probability sample, non-sampling errors can be reduced only through thoroughness in project planning and by careful control over all phases of the subsequent study. Sampling errors are the only errors that can be reduced by increasing sample size and, because the statistical formulas for computing sampling errors apply solely to probability samples, only in their case can we obtain statistical measures of the adequacy of sample size. How much sampling error there is in a non-probability sample and, consequently, the adequacy of its size, can be appraised only on a judgment basis. In any marketing research project where probability sample selection methods are used, however, larger sampling errors go along with smaller sample sizes, while smaller sampling errors accompany larger sample sizes.

Assuming, then, that probability selection methods are used, how can we get a sample of the right size—one that is neither too small nor too large? A sample is considered "too small" if the amount of sampling error present is more than can be permitted by the decision-making requirements of the problem under investigation. A sample is "too large" if its size is such that sampling error is reduced beyond the point that is really necessary; after a certain size of sample is reached, sampling error is reduced only slightly relative to the added costs incurred. Dr. L. O. Brown, pioneer marketing author and researcher, says there are four main considerations in planning the size of a sample. They are (1) the amount of

<sup>31</sup> The reader interested in exploring this matter of calculation further is referred to: H. W. Boyd, Jr. and R. Westfall, *Marketing Research: Test and Cases* (Homewood, Ill.: Richard D. Irwin, Inc., 1956), pp. 290-297, or Luck, Wales, and Taylor, *op. cit.*, pp. 190-193.

sampling error that is permissible, (2) the amount of risk the decision-maker is willing to assume that the sample results are, indeed, within the limits deemed permissible, (3) the amount of money available for the project, and (4) the basic nature of the research being planned.<sup>32</sup> How each of these considerations enters into planning the size of a probability sample will be discussed briefly below.<sup>33</sup>

**PERMISSIBLE SAMPLING ERROR.** The concept of "permissible sampling error" will be clarified through an example. Suppose that a manufacturer plans to launch a special promotional campaign in Buffalo at the point when "approximately" 50 per cent of the households in that city have heard of his product. Suppose, further, that management considers "approximately" to mean within plus or minus 5 per cent—i.e., the decision to launch the special campaign will be made if sample results show that as few as 45 per cent of the households know of the product. If the sample size actually used turned out to be too small (e.g., so small that the sample percentage might vary as much as 10 percentage points from the true percentage) management might make the wrong decision simply because of a too-small sample. Sample results might, then, show that only 40 per cent of Buffalo households had heard of the product, whereas the true percentage might be as high as 50 per cent. Management, then, because of the presence of too much sampling error, might be led into making an incorrect decision on a problem considered critical. Sampling error, as we said before, is reduced by increasing sampling size; so, the permissible sampling error—the amount that can be present in sample results without causing incorrect decisions—is an important consideration in planning the required size of sample.

**DECISION-MAKER'S WILLINGNESS TO ASSUME RISK.** Let us continue with the above illustration. How "confident" does the manufacturer want to be that the sample results in Buffalo are within his specified limits of permissible sampling error? With respect to the Buffalo sampling percentage, does he want to be 95 per cent confident, 68 per cent confident, or some other degree of confidence? Suppose he says he wants to be 95 per cent confident—i.e., he wants the chances that the Buffalo sample percentage will be within the specified limits of permissible sampling error to be 95

<sup>32</sup> L. O. Brown, *Marketing and Distribution Research*, 3rd ed. (New York: Ronald Press, 1955), pp. 269-275.

<sup>33</sup> More complete explanations and the details of the statistical manipulations involved in determining sample size are to be found in most marketing research textbooks. For instance, see: Brown, *op. cit.*, pp. 239-289, or Luck, Wales, and Taylor, *op. cit.*, pp. 190-200. These explanations form important segments of marketing research courses, and your authors believe that they should not be allowed to take up too much space in a book devoted to basic marketing.

out of 100 (or 19 out of 20).<sup>34</sup> The sample size in Buffalo, therefore, would have to be large enough so that in 19 out of 20 cases, the percentage value obtained through sampling would not be more than plus or minus 5 percentage points (the manufacturer's permissible sampling error) away from the true percentage value in the population (all households in Buffalo). If the manufacturer desired 99 per cent confidence, the sample size would have to be much larger; if he could get by with 68 per cent confidence, the sample size could be much smaller. Therefore, the amount of risk of obtaining incorrect information that a decision-maker is willing to assume has a definite effect on the required size of sample—the less risk he will assume, the larger the sample has to be; the more risk he will assume, the smaller the sample can be.

**MONEY AVAILABLE FOR THE PROJECT.** Sometimes, management's needs as to permissible sampling error and percentage of confidence are such as to indicate a larger-sized sample than the money available will allow. When this happens, one thing that might be done is to "scale down" the requirements as to permissible sampling error and desired confidence percentage, recognizing that some information, even though probably less reliable than the decision-maker would prefer, may be better than no information at all. Another thing that might be done, of course, is to allot more money to the project; this might be appropriate if the research goal is to obtain data pertaining to an extremely important decision, such as one involving the cultivation of an entirely new market segment. But if the extra money is simply unavailable, it may be wiser not to undertake the project at all rather than to use an inadequate sample whose results could, in fact, actually mislead the decision-maker. In setting sample size, then, some sort of balance must be found between the amount of money available for the project and the requirements as to permissible sampling error and desired confidence percentage.

**BASIC NATURE OF PLANNED RESEARCH.** Whenever a mass of sample data is reduced to an average (e.g., to an arithmetic mean) certain important details are obscured. In planning the size of the sample, then, care must be taken to guard against the possibility that the significance of the data will be lost in the average—i.e., that the average will not accurately reflect (or summarize) all of the sample data. For example, two counties might have the same average (arithmetic mean) income per household; but in

<sup>34</sup> Technically, this desire for "95 per cent confidence" is referred to as a "95 per cent confidence level"—which the statistician, or researcher, measures in terms of "standard errors"—and involves setting the "confidence limits" at 2 standard errors above and below the percentage shown by the sample results. For a detailed explanation of this matter, see: Boyd and Westfall, *op. cit.*, pp. 294-297.

County A, household incomes might range from zero to millions of dollars, whereas in County B such incomes might range from zero to only \$25,000. In order to reveal the existence of this difference in the range of income as well as to obtain the same average in both counties, the required size of sample for studying County A (with the extremely wide range) would have to be much larger than that required for studying County B (with a much narrower income range). To overcome this tendency for averages to cover up details that might be important, statisticians use what are called measures of dispersion to aid them in determining the proper sample size. The best-known and most-used measure of dispersion is "the standard deviation," which reveals something about the degree to which the values in a series vary.<sup>35</sup> When the dispersion is great (as in County A), the standard deviation is large and a larger-sized sample is needed to achieve a desired degree of precision in the results. When there is little dispersion and the data have considerable homogeneity (as in County B), the standard deviation is small and a smaller-sized sample can be used to achieve the same degree of precision. Thus, the sample size necessary to meet the three considerations discussed earlier—permissible sampling error, decision-maker's willingness to assume risk, and money available—varies with the extent to which the characteristic being measured (household income in our example) varies in the population being studied.

#### *Probability vs. Non-Probability Samples*

Now, then, what are the relative merits and limitations of probability and non-probability samples? Probability samples, as we have seen, enjoy a significant advantage in that they are the only kind where the amount of sampling error present is measurable, and where it is possible to predetermine the needed sample size. In non-probability samples, in contrast, judgment is the sole basis for appraising sample error and for determining sample size. Probability sampling, however, requires that individual items in the sample be chosen by a process of random selection (which involves using often-complicated probability mechanisms); thus, greater statistical competence and more time are required to plan and use probability sampling. For these reasons, then, probability samples generally cost more per observation (included in the sample) than non-probability samples. So it is not too surprising that most of the samples used in marketing research are non-probability samples; they cost less per observation, mainly because less time is taken, and relatively little statistical sophistication is required in planning the sample design and in selecting respond-

<sup>35</sup> "The standard deviation, [which is defined as] the root mean square of the deviations of the observations about their [arithmetic] mean, has become the almost universally accepted measure of absolute dispersion in economic and business analysis." R. Ferber and P. J. Verdoorn, *Research Methods in Economics and Business* (New York: Macmillan, 1962), p. 67.



ents. And often a non-probability sample is perfectly adequate for certain uses—e.g., for pretesting a questionnaire before putting it in final form. However, the great limitation of the non-probability sample still remains—since the chances of including a particular member of a population in the sample are undeterminable, the laws of probability do not apply and, hence, no measure of precision can be computed; and, similarly, it is not possible to predetermine the required size of sample. In other words, the fact still remains that in non-probability sampling, most of the selection of respondents is left to the accident of availability of persons and to the personal whims of interviewers,<sup>36</sup> and the size of the sample itself is left to the researcher's judgment. The conclusion seems fairly clear: where at all feasible, probability sampling methods should be used; but, if in a particular study only general estimates are needed and funds are limited, then an appropriate non-probability method will suffice. Professors Lorie and Roberts state that the choice between probability and non-probability samples should depend on the relative importance of the decision to be made. In their words: <sup>37</sup>

... nonprobability sampling is more attractive the less vital the decisions to be made on the basis of the study. The reason, of course, is that with non-probability sampling the bias and sampling variability can only be guessed, while probability sampling gives an objective evaluation of sampling error. Therefore in collecting data for very important decisions one does not like to risk nonprobability samples if probability samples are available.

#### BUDGETING FOR MARKETING RESEARCH

In budgeting funds for marketing research, management must answer three important questions: (1) How large should the total budget for marketing research be? (2) How much money should be invested in individual marketing research projects? and (3) What controls should management exercise over expenditures? Let us consider these questions in some detail.

##### *Size of Marketing Research Budget*

There are no pat solutions to the problem of how large the total marketing research budget should be. Actual expenditures vary from one company to another. They appear to vary with the size of the company, the nature of its operation, and the marketing leadership position that management sets for itself as a goal within the industry.

Large companies generally spend more dollars, although smaller percentages of their sales volumes, for marketing research than do small com-

<sup>36</sup> Luck, Wales, and Taylor, *op. cit.*, p. 217.

<sup>37</sup> J. H. Lorie and H. V. Roberts, *Basic Methods of Marketing Research* (New York: McGraw-Hill, 1951), p. 187.



panies. This is to be expected, for it is the very size of a large company which makes possible effective and economical use of many specialists (including marketing research specialists) that a small company finds it cannot afford—at least on its regular payroll. Research directors command annual salaries of at least \$12,500, with other expenses incurred in operating even a modest department equaling or exceeding that figure, so the minimum costs of having a marketing research department must run to at least \$25,000 per year. This is “a drop in the bucket” for a large company, but it represents a substantial percentage of total sales for many a small company. If a company is too small to budget at least this amount for marketing research, it *should* forgo having its own department, and arrange instead to invest what it can afford in the services of outside marketing research agencies and consultants. Typically, however, small companies with small marketing research budgets make little use of outside research assistance. In one study of 180 firms, for instance, 47 small firms with an average annual sales volume of \$870,000 spent nothing whatever on outside research assistance while 27 large firms with an average annual sales volume of \$337,000,000 spent more than 50 per cent of their marketing research budgets for outside help.<sup>38</sup> So even though a small company—operating, typically, with a part-time assignment of responsibility for marketing research (some executive has it “in addition to his other duties”)—may really need *more* outside help than a large firm, this study showed that it actually receives less outside help. It is often advisable, however, even in a large company with its own department, to retain such outside help, since demands for marketing research projects frequently exceed the capabilities of company personnel, or require more time to complete than they have available. Sometimes a project is simply too large for company personnel to handle, or it involves activities (e.g., field interviewing in numerous and scattered cities) which can be done more economically by an outside agency.

The nature of a company's operation also affects the size of its marketing research budget. For instance, if a company is a heavy user of advertising and sales promotional devices, if it maintains a large sales force, and if it distributes its products through fairly complex distribution channels, it is quite likely to be a heavy user of marketing research. Management, in other words, faced with these marketing conditions, must make numerous decisions and should, therefore, have greater needs for information that marketing research can provide. Such conditions are more typical of consumer goods companies than of industrial goods companies, and budgets for marketing research are usually larger in the consumer goods field.

Similarly, if the management of a company aims at achieving market-

<sup>38</sup> Crisp, *op. cit.*, pp. 20-21.

ing leadership in the industry, it is very likely to have a larger marketing research budget than a company whose management has lower aspirations. Of course, a company becomes an industry leader partly because of fortuitous circumstances, but even more because its management succeeds to a very high degree in adjusting product characteristics and company policies to the needs of different markets, doing so in such ways as result not only in sales but in profits. The way to industry leadership, then, is largely down the road of good marketing. And since good marketing depends on excellence in decision-making, management wants to base its decisions on the best information possible. That is the main reason why a company striving for marketing leadership will probably have a larger marketing research budget than a company which is content to settle for less.

One more point concerning the total size of the marketing research budget: very few companies spend more than they should. Most spend far more for production-oriented research than they do for marketing research, and this in spite of the fact that it usually costs less to manufacture a product than it does to market it. There are relatively few unexploited opportunities for improving business efficiency left in production; such opportunities remain mostly in marketing. Thus we should expect, at least in the well-managed concern, that the long-run trend of dollar expenditures for marketing research should be *up*—that is, if management is consciously trying to do a more efficient job of marketing through better decision-making.

#### *Costs of Individual Marketing Research Projects*

To the question of "how much should be invested in a particular research project," the theoretical answer is "something less than the value the decision-maker places on having the information produced by the research." Both amounts—the how much to invest and the worth of the resulting information—are difficult, if not wholly impossible, to estimate. Not only is it hard to put a dollar tag on the worth of specific items of information, it is at least as hard to say how much should be spent in obtaining that information. In spite of these difficulties in estimation, there are a few things we can say about the costs of individual marketing research projects. We can note, for one thing, that it never is worthwhile to launch a project so broad as to contemplate making available *all* the possible items of information about a particular decision situation. Of course, we can never get all this information anyway—because decisions are always made with reference to the future and there are always some uncertainties about the future. Research information can help reduce these uncertainties, but it cannot eliminate them entirely. Another thing we can say, as we said earlier in this chapter, is that the cost of a project is related to the degree of precision management expects to have in the

research results. Increased precision is bought at the price of higher project costs and greater amounts of time spent in processing the results. Another way of making the same point: the more confidence management wants to be able to put in the results, the larger and more expensive the sample, and the more costly the research techniques that are needed to obtain data which have the desired level of precision.

We should note, too, that individual projects vary in cost according to whether they are undertaken by company personnel, by outside agencies, or are joint endeavors of some kind. Outside research organizations are profit-making enterprises, and naturally price their services in excess of the actual costs incurred. Many outside researchers are reluctant to accept individual projects involving only a few hundreds or thousands of dollars, and some are interested only in projects involving tens or hundreds of thousands of dollars. Perhaps this explains why, as we mentioned earlier, small companies with small marketing research budgets make so little use of outside research assistance. However, most communities have smaller marketing research agencies and "free-lance" consultants who are more willing to take on small projects. Even marketing professors have been known to take on such projects—an academic version of "moonlighting."

#### *Managerial Controls over Marketing Research Expenditures*

In most companies, management exercises control over marketing research expenditures mainly through the annual budget. The marketing research director is responsible for estimating these expenditures for the coming budgetary period and for submitting his estimates to management for approval. He usually bases his budget estimates on some combination of anticipated costs of planned studies, contemplated changes in policy and personnel, past experience, and a reserve for contingencies and for projects unanticipated at budget-making time but which may have to be conducted during the budgetary period.<sup>39</sup> Management, at this stage of budget-making, can exercise control over marketing research expenditures in two ways—by approving or disapproving the proposed budget, and by raising or lowering requests for specific items of expenditure. In many companies, too, after the budget has been finally approved and the department is operating under it, management exercises further control by requiring specific approval for expenditures over some pre-determined amount and for expenditures involving the use of outside research assistance.<sup>40</sup>

The fact that most marketing research budgets include a "reserve for contingencies" deserves additional comment. Although certain expendi-

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<sup>39</sup> National Industrial Conference Board, *Studies in Business Policy*, No. 72 (New York: N.I.C.B.), p. 33.

<sup>40</sup> *Ibid.*, p. 34.

tures can be anticipated rather accurately for long periods into the future (e.g., the research director's salary), other expenditures are difficult (some impossible) to forecast for even a few months ahead. Virtually without exception, at the time the budget is being put together, it is impossible to foresee all the problems that may have to be investigated, let alone to estimate the costs of carrying through the resulting marketing research projects. Problems which at budget-making time may be non-existent, or simply not recognized as problems, may develop or become matters of importance, and it is obviously foolish to have to wait until the next budget period to begin investigations of them. Therefore, many writers on marketing research recommend that there be a substantial contingency reserve, and that "earmarked" funds in the budget be limited to items that can be estimated with considerable accuracy for long periods ahead.<sup>41</sup> Of course, some companies have less need than others for such contingency reserves to cover unanticipated demands for marketing research. Specifically, there is less need in companies which consider budgets flexible guidelines to expenditure rather than rigid expenditure limits which must be maintained regardless of the consequences.

### CONCLUSION

A marketing manager must have a keen understanding of marketing research's role in decision-making. He must understand how a carefully planned program of marketing research, designed to generate a flow of ideas and information, fits into the over-all decision-making process. He must appreciate the great potential marketing research has in furnishing him with data on the forces affecting marketing decisions—data on the uncontrollables, the competitive situation, the controllables, and on market measurement and planning. He must realize that the starting point of any marketing research study should be mutual agreement (by management and the researcher) on the identity of the problem, since both research time and money are wasted unless the problem for study is accurately pinned down. He should see to it that each research project is truly a planned search for information—that each has well-defined research goals, an organized effort, a step-by-step schedule, all directed toward obtaining as reliable information as possible within the limits of time and money available. He must know enough about sampling, because marketing research uses it so extensively, to allow him to evaluate research results intelligently. He must know the strong and weak points of probability and non-probability sample designs and fully ap-

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<sup>41</sup> For instance, see: Lorie and Roberts, *op. cit.*, p. 325; and Luck, Wales, and Taylor, *op. cit.*, p. 483.

preciate the significance of non-sampling and sampling errors in his appraisal of research results. Similarly, he must understand the main considerations entering into the determination of sample size, both to assist him in setting budgets for individual projects and in his later appraisals of resulting data. He should recognize how the total amount that should be budgeted for marketing research is affected by the size of his company, the nature of its operation, and its aspirations for marketing leadership. Finally, he should look upon the marketing research budget not as a rigid restriction on information-gathering activity but as a flexible guide, which can be adjusted with changing needs for information.

#### **QUESTIONS AND PROBLEMS**

1. "By contributing toward reductions in the cost of distributing goods from producer to consumer, marketing research makes it possible for the consumer to enjoy better products at lower prices than would otherwise be possible. By thus enabling each dollar to buy more, the entire standard of living of the people is raised to higher levels." Arthur C. Nielsen, Sr. in "Marketing Research—Past, Present and Future," *Nineteenth Charles Coolidge Parlin Memorial Lecture*, Philadelphia Chapter, American Marketing Association, May 21, 1963. Do you agree with Mr. Nielsen's contention? Why or why not?
2. Trace the historical reasons for the rising importance of marketing research. To what extent do these reasons account for the common organizational problems encountered in using marketing research? Discuss the various trends in modern business which appear now to be changing the way marketing research departments operate.
3. Discuss the potential contributions marketing research can make during each of the several stages in the decision-making process. Analyze the relationship of internal and external studies to marketing decision-making.
4. Comment on the following two statements:
  - a. "To manage a business well is to manage its future; and to manage the future is to manage information."
  - b. "It is equally as important for management to know when not to use research as to know when to use it."
5. Refer to the list naming 39 different major types of marketing research performed by American companies, and answer the following questions:

- a. What information of value to decision-makers might each type of study provide?
- b. Why is it that so few marketing research studies focus directly on the influences of uncontrollables?
- c. Why do so many focus on the influence of controllables?
6. Who should identify the problems to be studied—the marketing researcher or the marketing decision-maker? Justify the position you take.
7. Explain the meaning of each of the following:
  - a. preliminary exploration
  - b. situation analysis
  - c. permissible sampling error
8. Differentiate:
  - a. primary and secondary data sources
  - b. factual, opinion, and interpretative surveys
  - c. experimental method and observational method
  - d. population and sample
  - e. probability and non-probability samples
  - f. non-sampling error and sampling error
9. "Bad research is the cause of many marketing failures. Polling is the greatest contributor to marketing failure because it is conducted on the assumption that people can or will tell you why they buy a product." To what extent is this statement true? False?
10. Why should a marketing research project be a *planned* search for information? In planning a marketing research project, what types of decisions are required? Who should make them? Why?
11. What problems are involved in relating research objectives to the amount of money available for marketing research? Who should resolve these problems? Why?
12. Discuss the various criteria for choosing the research method(s) to be used in carrying out particular marketing research projects.
13. Explain how statisticians use the terms "accuracy" and "precision" in referring to samples.
14. How is sample size related to errors in sample results? When is a sample "the right size?" What does the decision-maker's willingness to assume risk have to do with sample size?
15. Compare and contrast the relative merits and limitations of probability and non-probability samples. Who should specify the type of sample—the marketing researcher or the decision-maker? Justify the position you take.

16. How do you explain the fact that the size of the marketing research budget varies greatly from company to company and from industry to industry?
17. How should the decision be made on the amount of money to invest in a particular marketing research project? Who should make this decision? Why?
18. Discuss the various controls over marketing research expenditures that management might set up.
19. Under what conditions might the manager of a marketing research department ask that a "reserve for contingencies" be included in the budget for his department?
20. You have just been hired by a medium-sized manufacturer of dog food to set up and manage a marketing research department. You are to report directly to the vice-president in charge of marketing but, since the company has not previously had a formally-organized marketing research department, there is no clear-cut statement of departmental objectives and you have no job description as yet. Formulate a statement of department objectives and write a job description for your position as department head.
21. The Catskill Toy Manufacturing Company with annual sales of \$2,500,000 sells its line of wooden toys mainly to schools and church organizations, but some mail-order business has been transacted with parents and other consumers. Even though the number of school-age children has grown significantly over the last decade, Catskill's unit volume has remained relatively stable with dollar sales increases being largely accounted for by price rises. The line of products ranges from building blocks sold in \$1, \$5, and \$10 sets to large wooden playground equipment priced as high as \$225. The company employs no salesmen, but sells its products through school supply houses and manufacturers' agents by means of a catalog distributed on request to interested parties. As the newly-appointed marketing vice-president of this concern, you have an advertising manager and a sales manager reporting to you and you have just been authorized to add a marketing research man to your staff. Outline the procedure you would follow in recruiting and selecting this new man. What kinds of studies would you want the new marketing research man to conduct and in what priority?

MARKET  
MEASUREMENT  
AND  
FORECASTING

14

In order to do marketing planning, which consists of setting marketing objectives and of determining and scheduling the steps necessary to achieve them,<sup>1</sup> management needs market measurements—i.e., sales forecasts. Our main concern in this chapter will be with the problems of making market measurements and using them for setting marketing objectives, which, as will be evident throughout our discussion, can be realistically set only if the company has the marketing capabilities to achieve them. Much of our discussion focuses specifically

<sup>1</sup> Committee on Definitions, *Marketing Definitions* (Chicago: American Marketing Association, 1960), p. 16.



on the analysis leading up to setting the sales volume goal which, you will recall, ranks second only to the net profit goal in the hierarchy of marketing goals.<sup>2</sup>

Before we deal directly with market measurements (i.e., sales forecasts), we must make sure that we have the proper perspective. We must realize that setting a sales volume goal is a critical decision since all other marketing planning decisions are linked to it. The actual setting of this goal is a phase of the part of marketing planning concerned with stating objectives and setting net profit, growth, and other goals—all of which are derived from the sales volume goal and affected by such considerations as the estimated costs of attaining the sales volume goal. The other part of marketing planning is concerned with the detailed outlining of the steps necessary to reach the stated objectives, of which the sales volume goal is one of a hierarchy of related objectives. Therefore, all phases of marketing planning are intertwined—and setting the sales volume goal is not only a critical decision but an important consideration throughout.

#### WHAT IS A SALES FORECAST?

A sales forecast is more than just a sales estimate. The single estimated figure we commonly think of as a "sales forecast" actually is the outcome of a great deal of planning work known as sales forecasting which, in general, involves a summing up of where a company is and how it got there, an assessment of its marketing capabilities, an evaluation of the uncontrollable and competitive forces influencing the company's future, and the drafting of a marketing plan under whose terms the company's prospects for future sales can be quantified and expressed in the form of a sales estimate. In the words of one executive, "Sales forecasting comes down to *equating opportunity and effort*"<sup>3</sup>—i.e., matching a given amount of opportunity for making sales with the types and amounts of marketing effort required to capitalize on that amount of opportunity. Different amounts of sales-making opportunity call for different types and amounts of marketing effort to capitalize on them—i.e., they call for different marketing plans. A particular sales estimate, then, has meaning only when it is tied to a proposed marketing plan. Furthermore, the forecaster visualizes a particular set of uncontrollable and competitive forces as influencing the company's future and this, too, affects both the sales estimate he arrives at and the marketing plan he proposes, (assuming one set of uncontrollable and competitive forces results in one sales estimate and one marketing plan, assuming another set results in a different sales estimate

<sup>2</sup> See Chapter 11, pp 256-257.

<sup>3</sup> P. G. Peterson, "The Use of Media in Making Sales Forecasts," in *Materials and Methods of Sales Forecasting* (New York: American Management Association, 1957), Special Report No. 27, p. 45.

and a different marketing plan, and so on) Taking all these things into account, we define a sales forecast as *an estimate of sales during a specified future period, which estimate is tied to a proposed marketing plan and which assumes a particular set of uncontrollable and competitive forces.*<sup>4</sup>

#### MAJOR CLASSES OF SALES FORECASTS

There are two major classes of sales forecasts: short-range and long-range. These differ not only in the length of the period they cover but in their uses. Short-range forecasts, also known as "operating" forecasts, usually cover periods up to a year and indicate estimated sales volumes under given marketing plans and particular assumptions as to uncontrollable and competitive forces affecting operations. The short-range sales forecast serves as a starting point for the entire planning and budgeting procedure, not only in the marketing department but in other departments and for the company as a whole. In addition, top management uses the short-range sales forecast together with the budget to coordinate the operations and practices of such departments as marketing, production, personnel, purchasing, and finance.

Long-range sales forecasts are for periods longer than one year (usually periods from two years and up) and, in contrast to short-range ones, are much more concerned with basic trends (e.g., population increases and shifts, changes in income distribution, changes in the relative importance of different types of middlemen), analyzing them, for example, to appraise needs for new products, changes in the sizes of the sales force and the advertising appropriation, and shifts in distribution policy. Such basic trends normally are slow-moving (they do not change very much over short periods) so the short-range sales forecast often, for practical purposes, devotes comparatively little attention to them. And since long-range forecasts do not have to take such things as present plant capacity or capital as "given," they are not bound by such restrictions as having to assume that the product line will be unchanged, that no great changes will occur in the size of the sales force and the advertising appropriation, and that no important shifts will be made in distribution policy. A long-range forecaster then, does not have to assume that the marketing capabilities of his company will be the same in the future as in the present, and this permits him to focus directly on measuring the extent of future sales-making opportunity. Because of this focus, management has a basis for planning major changes in production capacity, and for planning financial structure and a build-up of the marketing capabilities needed to

<sup>4</sup> This definition is somewhat different from that of the American Marketing Association. The A.M.A. defines a sales forecast as "an estimate of sales, in dollars or physical units, for a specified future period under a proposed marketing plan or program and under an assumed set of economic and other forces outside the unit for which the forecast is made." See: Committee on Definitions, *Marketing Definitions*, p. 20.

capitalize on whatever portion of the total long-range sales-making opportunity that management sets as its long-range goal.

Both classes of sales forecasts, however, are of great interest to marketing. The short-range forecast is an important part of short-range planning, since it is, by definition, a sales estimate tied to a particular marketing plan. It also provides information needed for setting sales territorial boundaries, establishing quotas (i.e., sales goals) for salesmen and products, and for planning advertising campaigns. The long-range sales forecast furnishes information needed for planning long-range changes in a company's marketing operation. Results of long-range forecasts are helpful, for example, in planning the addition of new products and the dropping of old ones—both decisions typically require longer than a year to carry out. Such forecasts are also useful in planning expansions or contractions in marketing personnel; for example, the impact of changes can be softened if changes are planned to take place gradually rather than abruptly. Other marketing uses of long-range sales forecasts include determination of advertising strategies and expenditures over long periods, decisions to open up new markets or to withdraw from old markets, and decisions to change the system of physical distribution (e.g., to close widely-scattered company-owned warehouses and handle all shipments directly from the plant). In general, then, the marketing department uses the short-range sales forecast in making the operating decisions needed to carry out a particular marketing plan, and it looks to the long-range sales forecast for guidance in making decisions on matters that have long-range implications. We will, in this chapter, concentrate mainly on the problems of short-range sales forecasting and the uses of short-range sales forecasts, but the significant role of long-range forecasting appears at various points, both in this and in succeeding chapters.<sup>5</sup>

#### **SALES FORECASTING AND BUSINESS PLANNING**

Sales forecasting leads ultimately to the setting of sales volume goals, and, as we shall see, such goals are pivotal in a company's round of planning activities. Decisions on sales volume goals are critical not only because of their controlling influence on other marketing decisions but because they strongly affect decisions in other departments throughout the business. It is helpful to think of business planning as the linking of two or more executive decisions with the aim of maximizing their joint effectiveness.<sup>6</sup> Bearing this concept of business planning in mind, then,

<sup>5</sup> For an extended discussion which focuses directly on long-range forecasting and planning, see: H. Lazo and A. Corbin, *Management in Marketing* (New York: McGraw-Hill, 1961), pp. 32-70.

<sup>6</sup> "Theory and Practice of Market Planning," *Cost and Profit Outlook*, Vol. 11, Nos. 7 and 8 (July-August 1958), p. 1.

consider how setting a sales volume goal answers the question of "how much of what kinds of goods should be produced," and also guides and limits other decisions both with respect to marketing and non-marketing problems. This decision, in other words, has important interdepartmental and company-wide implications and, for that reason, top management has a vital stake in it, often, in fact, making the final decision itself. Although sales volume goals are used as a basis for planning in all departments of a company, we will confine our comments to the important implications this decision has for planning in four departments: production, personnel, purchasing, and finance.

#### *Production Department*

In a "make and sell" business, close coordination of marketing and production operations is essential if the enterprise is to achieve its profit goal which, of course, is derived from the sales volume goal. Once top management approves the short-range sales forecast, it has established the basis for coordination of these two departments' operations. Using the short-range sales volume goal as a starting point, production planners have the information they need to draft production schedules and make other plans related to the level of plant operations. Receipt of the long-range sales volume goal by the production department is the signal to evaluate the adequacy of plant and equipment relative to market demand for a long period ahead, and subsequent analysis may reveal that production capacity should be expanded or altered (e.g., to change the product line). Both short-range and long-range sales forecasts should be converted into production plans in such ways that production costs are not raised unduly. In the short-range, production schedules and inventory levels must be so planned as not to significantly raise unit costs of production and, in the long-range, changes in plant facilities and capacity should be manipulated to the same end. Both short-range and long-range changes in production operations, of course, should be accomplished without unwarranted reduction in the company's capability to serve its customers satisfactorily (e.g., without resulting in long delays in shipping customers' orders).

#### *Personnel Department*

The personnel department's plans are also based to a large extent on sales forecasts. The personnel department uses the short-range sales estimate together with the production schedule in determining the company's manpower needs during the coming operating period. It uses long-range forecasts in planning any substantial changes in the size of the work force which may accompany predicted long-term increases or decreases in the company's business. Furthermore, the personnel department finds both classes of sales forecasts helpful in determining the scope and nature

of hiring, training, and re-training programs that may be involved in successfully reaching planned sales volume goals.

#### ***Purchasing Department***

The purchasing department is mainly interested in the short-range sales forecast. Purchase planners use the resulting sales volume goal in setting up the purchase schedule of materials needed for production but, of course, in doing so, they also refer to the production schedule which, as you will recall, is also based largely on the sales forecast. The short-range sales forecast also helps the purchasing department to anticipate the company's needs for routine supplies of all types (e.g., office stationery, maintenance materials, and fuel).

#### ***Finance Department***

The finance department uses the short-range sales forecast (combining it, of course, with its own specialized knowledge of such factors as credit policy and collection experience) in projecting the pattern of the probable inflow of cash. When this projected pattern is compared with the projected spending pattern (determined in large part by the purchase schedule which is also drafted on the basis of the sales forecast), financial executives can plan for such matters as short-term borrowings and temporary investment of excess cash. The finance department uses the long-range sales forecast as a basis for planning changes in the capital structure (i.e., for retaining earnings, selling stock, or floating bonds) as, for example, when the long-run sales outlook indicates the need for additional plant capacity and financing. Still another aspect of the finance department's interest in sales forecasts, both long-range and short-range, lies in the formulation of dividend policy—decisions to pay or not pay dividends, and to increase or decrease them should be tied in very closely with sales forecasts.<sup>7</sup>

Mr. C. H. Gager, an executive of the Coca-Cola Company, very neatly illustrates the close relationships of marketing and financial plans in these words: <sup>8</sup>

Many a good product and many a good plan for marketing have stubbed their toes for lack of funds—which, itself, is often the result of tackling too large a part of the market opportunity with insufficient capital. . . . New plant and machinery may not be had overnight or for nothing; new products depend on costly research; expanded volume, whether in old or new

<sup>7</sup> J. D. Dodge, "The Use of Sales Forecasts by Other Departments," in *Sales Forecasting: Uses, Techniques, and Trends* (New York: American Management Association, 1956), Special Report No. 16, p. 85.

<sup>8</sup> "Creative Marketing—A Key to Sales Success," in *Broadening Horizons in Marketing* (New York: American Management Association, 1956), Marketing Series No. 96, p. 57.

products, requires working capital as well as fixed capital; the financial situation may dictate a gradual expansion, and marketing plans need to be contrived to meet progressive steps of capacity.

#### *Responsibility of Marketing Management*

Top management usually reserves the right to approve, disapprove, or modify proposed sales forecasts, but the preparation of sales forecasts is normally considered a responsibility of marketing management, although the chief marketing executive may or may not actually do the forecasting work personally. In some companies, however, and certainly in many small ones, the marketing executive must do the sales forecasting or, at least, see to it that other interested parties—such as the general sales manager, advertising manager, product managers, the production vice-president, and the company treasurer—are coordinated in their efforts to put a forecast together. Even if a company has competent professionals on its payroll who are available for sales forecasting assignments, such as highly qualified marketing researchers or economists, the marketing executive still must stand ready to advise them, to furnish them with the benefits of his experience and thinking. Certainly he is, or should be, the one best qualified to speak with authority on such matters as the company's contemplated marketing plan, competitors' pricing strategies, forthcoming promotional campaigns (both by the company and its competitors), new developments that might affect sales of specific products, any prospective plans for changing sales manpower, and any move that may be afoot for stepping up or easing down on the selling emphasis given to individual products. All such matters bear directly on a company's ability to realize sales-making opportunity, and whoever does the actual sales forecasting work must be made aware of such information. Otherwise, there is little chance that the sales forecast will be useful in marketing planning.

#### **SHORT-RANGE FORECASTING PROCEDURES**

Short-range forecasting procedures vary among companies and among products, but any good procedure will be characterized by these six main features: (1) identification of uncontrollable factors affecting the general business outlook and the future sales of the industry and company, (2) a set of criteria for selecting those uncontrollable factors most useful for forecasting purposes, (3) a forecasting *method* (i.e., some system for arriving at an industry or company sales forecast in quantitative terms), (4) a scheme for breaking down the industry sales forecast into a company sales forecast and this, in turn, into smaller breakdowns for purposes of planning and control, (5) conscious attention to deriving a sales volume goal consistent with an appropriate mar-

keting plan, and (6) an evaluation system for appraising individual forecasts. In the following sections, we will examine the nature and importance of each of these features.

#### *Identifying the Pertinent Uncontrollables*

The first step in forecasting company sales is to identify the uncontrollables that affect the general business outlook and the selling opportunities that exist for the industry and company in the period being forecast. Economic uncontrollables, as a group, are usually the fastest changing, with changes in psychological and sociological uncontrollables normally influencing a company's sales volume very slowly. However, even though economic uncontrollables are likely to be the ones most closely scrutinized by the forecaster, he must also be on the alert for changes in psychological and sociological uncontrollables that are likely to be reflected through changes in economic uncontrollables.

Among the economic uncontrollables that the forecaster should consider are the various components of the "income-expenditures model": national income, gross national product, disposable personal income, consumer spending, private investment expenditures (i.e., investments in industrial goods, changes in business inventories, and residential construction), corporate profits, and compensation of employees. Other economic uncontrollables that may deserve consideration include the general price level, numbers of people employed and unemployed, consumers' propensities to save and to consume, and business expansion plans.

One special type of economic uncontrollable that usually should be carefully studied is the matter of inter-industry competition. Here the forecaster must try to determine the extent to which the products of the industry are in competition with the products of other industries. For example, in forecasting sales of butter, one must appraise the extent to which butter meets competition from butter substitutes, such as margarine. Usually, but not always, price is the main basis for inter-industry competition, and, as the price variation widens, the industry with the higher price tends to lose business to the industry with the lower price. The relative prices of products of competing industries, however, may or may not have important effects on sales-making opportunities, depending, among other things, on how much consumers actually know about comparative prices and on whether they consider significant the amount of money represented by the price.

Sometimes, inter-industry competition takes place on such non-price (i.e., non-economic) grounds as the psychological and the sociological. An instance of inter-industry competition founded on a psychological basis is provided by the butter and margarine producers, both of whom use "health" appeals. A sociological basis for inter-industry competition

is found in the marketplace battle of beer and hard liquors—most working class and lower-income groups appear to favor beer, with professional and executive classes along with higher-income groups favoring such hard liquors as bourbon, scotch, and gin—brewers direct some appeals to hard liquor consumers and distillers direct appeals to beer-drinkers, thus each industry seeks to enlarge its market at the other's expense.

Fairly often, the analyst finds that two of the same industry's products compete with each other. For instance, black-and-white TV sets compete with color-TV sets. Although some consumers clearly are in the market either for just one or the other, some consumers are prospects for either product. Often this "switch" group of potential buyers will make their decisions on economic grounds (mainly price, or the availability of credit), but sometimes their decisions will be swayed by psychological or sociological arguments (e.g., to keep up with the Joneses or to get ahead of them). Here we see a good instance of the interplay of economic, psychological, and sociological factors affecting the relative size of sales-making opportunities for competing products; such factors must be taken into account in forecasting sales of individual products.

Many other psychological and sociological uncontrollables can affect the general economic outlook and industry and company selling opportunities. The size of the total population and changes in its composition (i.e., by age groups, types and sizes of families, geographical shifts, birth and death rates, and so on) are significant factors to consider in forecasting sales of many products (e.g., groceries and drugs, clothing and wearing apparel, appliances and furniture, sporting goods, baby carriages, wheel chairs, and coffins). Public attitudes on the chances of war are real considerations in sales forecasting for some products, especially those the public remembers as being scarce during wartime (e.g., shoes, coffee, tires and appliances). Public optimism or pessimism concerning the general economic outlook (e.g., the chances of continuing prosperity or impending recession) also affects industrial buyers' and consumers' intentions to buy or to refrain from buying items involving major outlays. Similarly, the trend of fashion and the rapidity with which a new fashion spreads affects sales in many industries (e.g., ladies' millinery and men's ties). And, sometimes, for various reasons including habit, social group influences, cultural and religious influences, and the accumulated impacts of industry and anti-industry propaganda, large numbers of consumers are psychologically predisposed either for or against the purchase and use of particular products.

Identifying the uncontrollables that exert significant influences on a product's sales requires that management stay well informed on the firm's operating environment. Determining which uncontrollables are significant is a matter of keeping up-to-date on the business news and of



being well-informed on the nature and significance of the numerous uncontrollables affecting marketing. Part Two of this book surveyed the general nature of the main uncontrollables and explained some of the many ways they affect marketing. Beyond having such general knowledge, a marketing executive needs to have access to information which can be provided through studies of the influences uncontrollables have on the marketing operations of his particular company. If he has a continuous flow of such information, he stands a good chance of being able to anticipate any important changes in the company's sales outlook that may be impending because of changes in the impact of different uncontrollables.

### Selection Criteria

Because the number of uncontrollables affecting a company's sales prospects is usually very large, the sales forecaster (in an effort to reduce the complexity of the forecasting problem) must select a small number of uncontrollables (i.e., a manageable few to work with). In selecting this set of uncontrollables, he needs some selection criteria. Three of the main criteria ordinarily recommended for this purpose are *variability*, *potency of influence*, and *measurability*.<sup>9</sup> Each uncontrollable should be appraised against each selection criterion, and only if it meets all three criteria should the forecaster include it among those uncontrollables for use in making the forecast.

**VARIABILITY.** An uncontrollable is considered to have the necessary variability if it can be expected to vary significantly during the period being forecast. All uncontrollables, of course, vary over time, if the time is long enough. However, changes in some uncontrollables occur at *very* slow rates, which makes it safe to ignore them in short-range forecasting but not in long-range forecasting. For example, the age composition of the U.S. population undoubtedly affects sales of diamond rings, but the age composition changes very slowly (Joel Dean says it moves as slowly as a glacier),<sup>10</sup> so slowly that diamond ring sales in any one year hardly vary from those of either the preceding or succeeding year, at least for causes traceable to changes in the population's age composition; but, a 25 year forecast of diamond ring sales could be very much in error if it overlooked changes in the number of people of marriageable age. By contrast, both short-range and long-range forecasts of diamond ring sales can be greatly affected by changes in consumers' disposable income,

<sup>9</sup> See: J. Dean, *Managerial Economics* (Englewood Cliffs, N.J.: Prentice-Hall, 1951), p. 165; and J. A. Howard, *Marketing Management: Analysis and Decision* (Homewood, Ill.: Richard D. Irwin, 1957), p. 123.

<sup>10</sup> Dean, *op. cit.*, p. 165.

an uncontrollable that varies considerably from one year to another. Substantial changes in some uncontrollables (e.g., consumers' disposable income) occur within relatively brief time periods, whereas inconsequential changes occur in other uncontrollables (e.g., the population's age composition) during the same time periods. Most of the uncontrollables that vary greatly during short time periods are economic forces, since most psychological and sociological forces change slowly from one period to the next; nevertheless, the forecaster has to be on the alert for "crazes," "scares," and "waves of hysteria"—evidences of the mixed influence of psychological and sociological factors—that may strongly influence product sales even within a relatively short period of time. However, the forecaster should, for short-range sales forecasting purposes, do his best to select for careful study only those uncontrollables that are most likely to vary significantly during the period being forecast.

**POTENCY OF INFLUENCE.** An uncontrollable may have some influence on the sales of a particular product, but the relative potency of its influence is also an important selection criterion. Sales of automobiles, for instance, are greatly influenced by disposable personal income of consumers and the availability and cost of installment financing. Auto demand is also influenced by the building of new interstate highways, but this influence is minor and can safely be ignored in short-range sales forecasting. Disposable personal income is most often a potent influence on sales in the case of durable goods (e.g., automobiles, appliances, and furniture), but it is a far less potent influence on sales of nondurables and services (e.g., bread, salt, haircuts, and admissions to sporting events).<sup>11</sup>

**MEASURABILITY.** Because we want the sales forecast to be expressed quantitatively, we must confine the selection of uncontrollables to those we can measure. Perhaps one reason why the economic uncontrollables are so widely used in short-range forecasting is not only that many of them are measurable, but that published quantitative information on many of them is readily available (e.g., in census and other government reports, and in the files of private economic consultants). Psychological uncontrollables, in contrast, are difficult to quantify, and even to attempt measuring them involves using motivation research and other techniques requiring special skills. The same holds for most of the sociological variables, except for the demographic (population) uncontrollables where census information is readily available.

<sup>11</sup> See Chapter 7 on this matter.

A special problem in applying the measurability criterion occurs in situations where the statistical data representing some uncontrollable do not constitute a fully satisfactory indicator of the extent of sales opportunity for the product whose sales are being forecasted. Consider, for example, the influence of disposable personal income of consumers on automobile sales. Forecasters of automobile sales have to be extremely wary of using figures representing aggregate (i.e., the total population's) disposable personal income since such data reflect neither changes in the distribution of income among consumers nor shifts in income distribution among different geographic areas. Thus, a forecaster of automobile sales has to adjust such data according to his best information on the distribution of income among different classes (studies on this are published occasionally in the *Survey of Current Business*), and on the geographical distribution of income (studies on this appear annually in the *Survey of Current Business*). It makes a considerable difference to a forecaster of automobile sales whether a billion dollar increase in disposable personal income is received mainly by midwestern farmers or by New York City wage earners since midwestern farmers generally are much more interested in buying automobiles than are New York wage earners.<sup>12</sup>

Sometimes, too, the sales forecaster must substitute one uncontrollable for which he has a measure for another uncontrollable for which he has no measure. For instance, consider the problem of developing a forecast for gasoline and related products at a prospective site for a service station. Even though service station sales are logically related to the level of consumer income in the trading area, usually no direct measure of this uncontrollable is available. Consequently, in this sort of sales forecasting problem, often an estimate of rental values is used as a substitute (i.e., as a proxy) for a direct measure of the level of consumer income in the trading area.<sup>13</sup>

#### *Forecasting Methods*

There are two main classes of forecasting methods: unsophisticated and sophisticated. The unsophisticated methods rely primarily on judgment to produce sales forecasts; the basic reasoning underlying these methods is easily understood. The sophisticated methods, in contrast, involve the application of statistical techniques of varying degrees of difficulty and, perhaps because of this, are used mainly by companies that employ professional forecasters. We will consider four methods at some length in the following sections: the poll of sales force opinion and the survey of customers' buying plans (both unsophisticated methods), and correla-

<sup>12</sup> F. D. Newbury, *Business Forecasting* (New York: McGraw-Hill, 1952), p. 242.

<sup>13</sup> Dean, *op. cit.*, p. 165.

tion analysis and econometric model-building (both sophisticated methods).<sup>14</sup>

**POLL OF SALES FORCE OPINION.** Under this method, known also as the grass roots approach, individual salesmen forecast sales for their respective territories; then these individual salesmen's forecasts are combined and modified, as management thinks necessary, to form the company sales forecast. Advocates of this approach claim that it has two great merits: (1) the specialized knowledge of those company personnel closest to the market is brought to bear on the forecasting problem, and (2) forecasting responsibility is put squarely on the shoulders of those who must later produce the sales results. Four of the many criticisms of this approach are that (1) salesmen usually are not trained forecasters and are ill-informed on the factors influencing sales, (2) many salesmen are born optimists and are inclined to overestimate their possibilities of making sales, (3) the approach makes no provision for bringing the systematic consideration of uncontrollables into the analysis and, similarly (4) the approach does not provide for discovery of important facts through statistical analysis of historical data. To some extent these objections can be overcome through training salesmen in forecasting techniques, by orienting them on the sales-influencing uncontrollables, and by adjusting for consistent biases in individual salesmen's forecasts detected through study of their forecasting records. For most companies, however, implementing such corrective actions would be an almost endless task since personnel turnover among salesmen is constantly going on and new men (whose biases are unknown at the start) would be submitting their forecasts along with the forecasts of long-experienced salesmen with known forecasting biases. In short, this method is based to such a large extent on judgment that it is an unreliable approach for most companies to use as their only forecasting method. The poll of sales force opinion, where used, usually serves as a method of getting an alternative estimate of sales for use as a check on a sales forecast obtained through some other approach.

In spite of what we have just said, some companies do find the poll of sales force opinion a useful sales forecasting approach. Harris-Inter-type Corporation, a manufacturer of printing equipment, polls all of its salesmen not only as to how much they expect to sell, but as to how many of each model of each product they expect to sell. Each of the company's 15 district sales managers supervises the poll for his district and prepares individual forecasts in consultation with the salesmen. District

<sup>14</sup> For an extended explanation of numerous methods of market measurement and sales forecasting, see: F. E. Hummel, *Market and Sales Potentials* (New York: Ronald Press, 1961), pp. 83-226.

managers' reports are combined into the "district managers' estimate," which is then reviewed by an executive committee composed of the company forecaster (who makes a forecast of the general business outlook), the coordinator of production planning, and others. This committee brings the specialized knowledge and skills of its members to bear on the problem—i.e., their knowledge and opinions on the economic outlook, trends in the printing equipment and related industries, marketing research studies, marketing plans, proposed new products, and so on. This committee adjusts the district managers' estimate and comes up with a "preliminary sales forecast," which is then reviewed in conference with the marketing vice-president and the executive vice-president. The results of that meeting become the "official company sales forecast."<sup>15</sup> Notice that Harris-Intertype relies on the salesmen's estimates only as a starting point, adjusting them in the light of specialized knowledge as the forecast is processed through successive management levels. Notice, too, that this company has a company forecaster who prepares a general business forecast which can be used to check the "reasonableness" of the forecast arrived at through the procedures described above. Thus, this company's use of the poll of sales force opinion method is so modified as to partially overcome some of the objections to this approach mentioned earlier, but it still relies more on judgment than it does on statistical analysis. Harris-Intertype is willing to settle for this relatively unsophisticated sales forecasting approach because, among other reasons, it has found that salesmen's estimates of the product mix (proportions that various products, models, and sizes bear to the total sales forecast) are its best source of guidance in scheduling various products, models, and sizes for production.<sup>16</sup>

**SURVEY OF CUSTOMERS' BUYING PLANS.** What could seem more like a sensible sales forecasting approach than that of asking customers what their intentions are with respect to buying the manufacturer's product? This approach is used much more by industrial marketers than by consumer goods marketers. Probably this is because the approach is best adapted for use in situations where the potential market is made up of small numbers of customers and prospects, substantial sales are made to individual customers, the manufacturer sells direct to users, and customers are concentrated in a few geographical areas—all of which conditions are more frequent in industrial marketing than they are in consumer goods marketing. Under such conditions, it is feasible to survey

<sup>15</sup> L. K. Miller, "Economic and Sales Forecasting in an Industrial Company," in R. L. Clewett (Ed.), *Marketing's Role in Scientific Management* (Chicago: American Marketing Association, 1957), pp. 378-379.

<sup>16</sup> *Ibid.*, p. 377.

a sample of customers and prospects, obtain estimated requirements for the manufacturer's product during the planning period, and project the sample results in order to obtain a sales forecast. The magnitude of the sample survey needed under these conditions does not require expenditures of time and money which are out of line with the usefulness of the results.<sup>17</sup> Like the results of polls of sales force opinion, however, the results of such surveys should be tempered by management's specialized knowledge and access to pertinent information gathered from other sources. It is dangerous, in other words, to use the results of either a survey of customers' buying plans or a poll of sales force opinion as the sole basis for a company's sales forecast. The main specific objection to the survey approach to sales forecasting is that it assumes that customers know what they are going to do and, in addition, it assumes that buyers' plans, once made, will not change—at least part of the time, either or both assumptions are likely to be unwarranted.

Talon, Inc., a manufacturer of slide fasteners, combines the survey of customers' buying plans with the poll of sales force opinion approach. Talon is reported to base the amount of its sales forecast mainly on information gathered through a mail survey of its main industrial customers (chiefly apparel, handbag, leather goods, footwear, sporting goods, and military equipment manufacturers) and from field interviews with department store and other retail store buyers. The forecast arrived at by these means is checked and supplemented by forecasts made by the company's district managers and salesmen for the same list of principal customers. One reason why this particular approach seems to suit Talon is that the company's short-range forecasts are made for very short periods—six months rather than the usual year—and customers are much more likely to know their buying plans for six months ahead than they are for a year ahead. In Talon's case, short-range forecast periods of more than six months are ruled out because of the rapid changes in market conditions and customer demand, both complicated by the seasonal and style changes involved.<sup>18</sup>

Lockheed Aircraft Corporation uses a unique variation of the survey of customers' buying plans—unique because it really is not a survey (the customers are not questioned directly) and because Lockheed personnel play the roles of leading customers in simulated decision-making situations. In this approach, which the company calls "prudent-manager forecasting," management (1) brings together a small group of seasoned company specialists representing such functions as marketing research,

<sup>17</sup> For some brief case histories of how five industrial marketers use surveys of customers' buying plans as important parts of their sales forecasting procedures, see: R. N. White, "Take the Sacred Cows Out of Sales Forecasts," *Sales Management*, Nov. 18, 1960, pp. 69-76.

<sup>18</sup> Newbury, *op. cit.*, pp. 249-250.

marketing, finance, engineering, and administration, and (2) asks them to assume the role of decision-making managers in a customer firm that is evaluating one of the firm's products for purchase. This group of specialists, in effect, assumes the position of the customer's management and attempts to prudently evaluate the facts available (on Lockheed's and competitors' products) and to arrive at the preferred purchase decisions—preferred from the customer's viewpoint. This role-playing approach to sales forecasting would seem to hold possibilities for companies selling products to markets characterized by relatively small numbers of large buyers and sellers (i.e., companies in Lockheed's situation). The approach, too, is best suited to marketing situations where customers make their buying decisions on rational rather than emotional grounds—i.e., where customers typically buy "prudently."<sup>19</sup>

Consumer goods marketers have also been interested in the possibility of using survey data on consumers' buying intentions as a basis for sales forecasting. The availability in published form of such periodic studies as the *Annual Survey of Consumer Finances*, the *Quarterly Survey of Consumer Buying Intentions*, and the *Survey of Consumer Attitudes and Buying Plans* has sharpened this interest, especially in consumer goods companies marketing the kinds of durable goods on which these surveys regularly report (e.g., automobiles, furniture, major appliances, etc.).<sup>20</sup> The Ford Division of Ford Motor Company is reported to have used information on consumer buying plans in preparing its forecasts of automobile industry sales.<sup>21</sup> However, relatively few companies have used such survey data as the *main* basis for arriving at their sales forecasts, although an increasing number are finding the surveys useful as a way of obtaining "check" forecasts against which to compare sales forecasts derived through other methods. Many forecasters are somewhat skeptical about the reliability of the attitudinal data reported by the various surveys. For example, one careful student who analyzed the reliability of the attitudinal data provided in the reports of the *Annual Survey of Consumer Finances* concluded, among other things, the following:<sup>22</sup>

1. There has been limited success in indicating the direction of change in total sales of consumer durables (i.e., in predictions of whether total sales of these items will go up or down). Six such changes occurred in the period December 1952 to October 1958 and only two were correctly predicted.

<sup>19</sup>G. A. Busch, "Prudent-Manager Forecasting," *Harvard Business Review*, Vol. 39, No. 3 (May-June 1961), pp. 57-64.

<sup>20</sup> See Chapter 7 for descriptions of these surveys, illustrations of the data they contain, and the sources from which they are available.

<sup>21</sup> Howard, *op. cit.*, pp. 128-129.

<sup>22</sup> S. Paranka, "Marketing Predictions from Consumer Attitudinal Data," *Journal of Marketing*, Vol. 25, No. 1 (July 1960), pp. 46-51.

2. Past survey results have been more accurate in predicting the direction of change of sales of specific consumer durables than the total sales of these goods. There has been relatively high accuracy in the case of predicting changes in sales direction of used cars, houses, and furniture and relatively low accuracy in the case of television sets and refrigerators.
3. Past survey results have generally been of little assistance in predicting the magnitude of sales of durable goods.

Even though we included the survey of customers' buying plans among the so-called unsophisticated sales forecasting methods, it *can* be rather sophisticated—that is, if it is a true survey (in the marketing research sense) and if the selection of respondents is made by probability sampling methods. Because the intent of such a survey, however, is to gather opinions (e.g., “what major appliances do you think you will buy during the next six months?”) rather than facts (e.g., “what major appliances have you bought during the past six months?”), substantial amounts of non-sampling error are likely to be present in the results—respondents do not always have well-formulated buying plans and, even if they do, they are not always willing to relate them to an interviewer. We include the survey approach among the unsophisticated methods, then, because in actual practice the survey is usually very informal, with little or no attention paid to the composition of the sample, and minimum effort devoted to measuring sampling and non-sampling errors. Therefore, although the survey approach to sales forecasting can be sophisticated (where the role of judgment is minimized), in actual practice so much judgment enters into the survey design and interpretation of survey results that we can only classify the approach as unsophisticated.

**CORRELATION ANALYSIS.** Statistical techniques are used in correlation analysis to determine and measure the association between sales (called the “dependent variable”) and one or more factors (such as disposable personal income or population) influencing demand (called the “independent variables”). Ferber provides a brief description of sales forecasting by means of correlation—“the method involves the fitting of an equation to explain the fluctuations in sales in terms of related and presumably causal variables, substituting for these variables values considered likely during the period to be forecasted, and solving for the value of sales.”<sup>23</sup> Hence, forecasting sales by this method is a three-step process: (1) identification and selection of uncontrollables (i.e., independent variables) causally related to sales (see the discussion of this step presented on pages 352-356 of this chapter), (2) construction of a forecast of trends in these related uncontrollables, and (3) derivation of a sales forecast from the

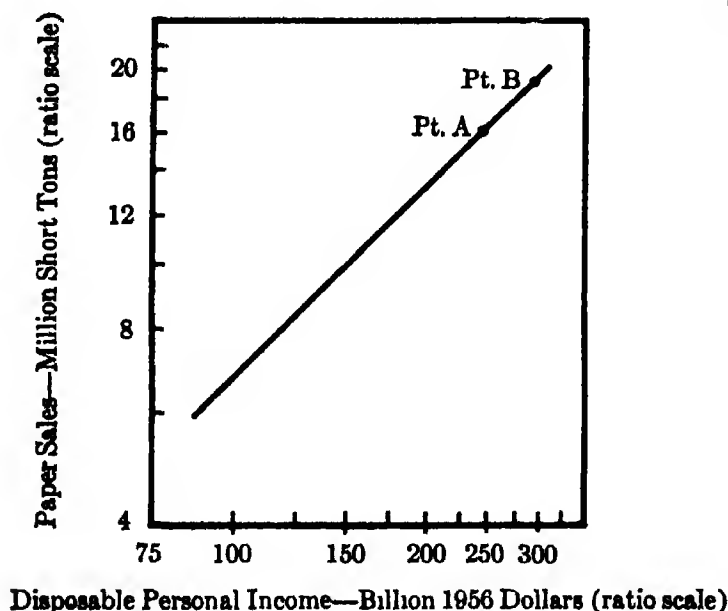
<sup>23</sup> R. Ferber, “Sales Forecasting by Correlation Techniques,” *Journal of Marketing*, Vol. 18, No. 3 (January 1954), p. 219.



forecasted values assigned to the related uncontrollables. Let us examine a few illustrations of the correlation analysis approach to sales forecasting.

First, let us consider a situation where the relationship between "sales" and an uncontrollable affecting demand can be shown graphically. Consumer purchasing power is this sort of uncontrollable: it is a major determinant of the demand for many consumer goods as well as for products having both consumer and industrial uses. An example of a product sold to both consumer and industrial markets is paper (a broad product category, which includes such items as newsprint, printing paper, fine paper, industrial paper, wall paper, and tissue paper). We might, then, expect that changes in sales of paper would be closely related to changes in con-

Figure 14.1



Sources: Adapted from C. Winston and M. A. Smith, "Analysis of Long-Term Markets," *Survey of Current Business*, November 1957, p. 18.

sumer purchasing power. Figure 14.1 shows the historical relationship (which existed from 1929 to 1957) between paper sales (in millions of short tons) and disposable personal income (in billions of 1956 dollars). Disposable personal income is used here as the measure of consumer purchasing power and was converted into "real dollars" of disposable personal income by deflating the actual dollar figures for each year by a price index (in which 1956 was taken as the "base year" and assigned a price index value of 100). The approximate 45-degree angle with which the line of relationship cuts the axis on which paper sales are scaled indicates that the degree of correlation (i.e., the slope of the line) is close to "unity"—meaning that paper sales tend to respond in a one-to-one relationship to changes in real disposable personal income. Because ratio scales are used

on this chart<sup>24</sup> (rather than arithmetic), the one-to-one relation shown by the slope of the line really indicates that a given *percentage* change in real disposable income will be accompanied by the same *percentage* change in paper sales. Thus, for instance, if real disposable personal income rises from \$250 billions (see Point A on the chart) to \$300 billions (see Point B), which is a 20 per cent increase in disposable personal income, the chart indicates that paper sales will rise from approximately 16 million short tons to around 19.2 million short tons, which is also a 20 per cent increase. Notice that this uncontrollable (i.e., real disposable personal income) meets, for purposes of forecasting paper sales, all three of the selection criteria we discussed earlier. It shows variability from period to period; the one-to-one graphical relationship demonstrates the potency of its influence on paper sales; and it is measurable. In forecasting paper sales, then, real disposable personal income might well be selected as the "independent variable," which would, in effect, transpose the forecasting problem from one of directly predicting paper sales to one of predicting a value for real disposable personal income from which a predicted value of paper sales can be derived.

Of course, there are many forecasting situations where sales are influenced not nearly so strongly by one independent variable as by several independent variables acting together. Rosenzweig, in applying "multiple" correlation techniques to his analysis of the dependent variable "demand for aluminum" (A), used four independent variables—gross national product (G); a time trend representing growth in aluminum consumption over the period being studied (T); the ratio of aluminum prices to steel prices (L); and the ratio of aluminum prices to copper prices (M)—and eventually arrived at the following mathematical expression of the relationship between the dependent variable and the four independent variables.<sup>25</sup>

$$\log A = -3.439 + 2.917 \log G + .002T - .258 \log L + .078 \log M$$

In deriving this equation, Rosenzweig worked with data for the years 1919-1954, a period during which annual aluminum consumption rose from 165.9 million pounds to 3,010.0 million pounds. In forecasting the 1965 demand for aluminum, Rosenzweig substituted estimated values for the four independent variables (G, 480; T, 46; L, 300; and M, 25) which resulted in a 1965 forecast of 8,425.0 million pounds. Notice, in this in-

<sup>24</sup> Arithmetic scales would not have been very practical to use in graphing this relationship, because of the great difference in the magnitudes of the two series (paper sales being in *millions* of short tons, and disposable personal income in *billions* of dollars). Using ratio scales, in effect, brings two series of greatly different magnitudes into the same magnitude and, thus, facilitates the detection of relationships.

<sup>25</sup> J. E. Rosenzweig, *The Demand for Aluminum* (Urbana, Ill.: Bureau of Economic and Business Research, University of Illinois, 1957), pp. 27-28. (NOTE: In this equation, "log" stands for "logarithm" and the first term, -3.439, is a constant).

stance, that although this equation was used to obtain a long-range sales forecast, it could also have been used for obtaining a short-range sales forecast or, for that matter, a forecast applicable to three years ahead, four years ahead, and so on. However, for purposes of short-range sales forecasting, such independent variables as the time trend ("T" in the above equation) can safely be disregarded since they do not vary much from one year to the next.

Now that we have illustrated both simple correlation analysis<sup>26</sup> (the paper sales and disposable personal income relationship) and multiple correlation analysis (the aluminum demand example), what can we say about the advantages and limitations of using these techniques for sales forecasting? The fundamental objection is that the forecasting problem is merely transformed from one of predicting the dependent variable (sales) to one of predicting the values of the independent variable(s). This objection can be overcome, however, providing that the forecaster finds and uses independent variables that "lead" (come before) the dependent variable "sales" since, then, the *present* values of independent variables can be used to forecast the *future* value of sales.<sup>26</sup> Such leading series are widely used in forecasting sales of industrial goods, whose sales are often derived from sales of end products.<sup>27</sup> For example, sales of automobiles are likely to lead sales of various steel fabricating parts going into automobile manufacture. But the problem in using a lead-lag relationship for forecasting is that the time interval between a change in the leading series and the resulting change in the lagging series (i.e., in sales) is usually unstable; it varies in duration and its length may contract or expand in highly unpredictable ways. Nevertheless, if the forecaster finds a close correlation between sales of the product and one or more uncontrollables, regardless of whether changes in these uncontrollables lead or are coincident with changes in sales, he has an opportunity to improve the quality of his estimates of forecasted sales by using the predictions of experts for the values of the independent variables. Expert predictions are available for such uncontrollables as gross national product, disposable personal income, and the Federal Reserve Board's Index of Industrial Production. Unfortunately, it is all too easy for a forecaster to become complacent with all this help, and he may come to consider sales forecasting a purely mechanical operation, perhaps even to the point where he stops thinking about what he is doing! Nothing could be more foolish, for the techniques of correlation analysis provide a projection which assumes a continuation

<sup>26</sup> For an analysis of various leading, coinciding, and lagging series of economic data, see: H. M. Platt, *Economic Indicators: Their Use in Business Forecasting* (Hanover, N.H.: The Amos Tuck School of Business Administration, Dartmouth College, 1959), Tuck Bulletin No. 21.

<sup>27</sup> J. B. Boulden, "Fitting the Sales Forecast to Your Firm," *Business Horizons*, Vol. 1, No. 1 (Winter 1958), p. 69.

of past experience with respect not only to the uncontrollables affecting sales but as to the nature of the relationship. In projecting for some future period, then, the forecaster should keep in mind that the "mix" of uncontrollables affecting sales may change and, indeed, even the nature of this relationship. Therefore, the forecaster should bring into his analysis any additional information which might materially alter the predictions based on past experience. For example, a high degree of correlation existed in the pre- and early post-World War II years between the sales of book paper and real consumer purchasing power, but this correlation has been significantly modified since then by the accelerated expansion of the school-age population. In forecasting sales of book paper, then, the rate of growth of the younger age groups is an additional important factor to keep in mind.<sup>28</sup> We must conclude, then, that one of the real dangers in using correlation analysis techniques for sales forecasting lies in the assumption that relationships which held in the past will hold in the future; such relationships can be upset.

In spite of its serious limitations, correlation analysis will undoubtedly continue to be widely used in sales forecasting. One of the reasons, according to Professor Lorie, is that "it is one of the very few techniques which can be readily learned by people receiving low wages and which has the comforting—albeit superficial—appearance of 'scientific' precision."<sup>29</sup> Another reason why this method will probably continue in wide use is that, in comparison to such forecasting methods as the poll of sales force opinion and the survey of customers' buying plans, correlation analysis tends to keep judgment from playing the major role. As we have seen, however, herein lies a danger: Judgment may be relegated to so minor a role that the forecast suffers from being statistically beautiful but unrealistic from the standpoint of common sense. All forecasting situations, then, require the application of a certain amount of judgment, and the forecast arrived at through correlation analysis is no exception.

**ECONOMETRIC MODEL-BUILDING.** For companies marketing consumers' durables (e.g., household appliances and furniture), econometric model-building appears to hold considerable promise as a method of sales forecasting. This approach uses a mathematical model in the form of an equation or system of equations to represent a set of relationships among different demand-determining uncontrollables and sales (which, here again, is considered as the dependent variable), and the model is then used to produce a sales forecast. You may be thinking "But doesn't that

<sup>28</sup> C. Winston and M. A. Smith, "Analysis of Long-Term Markets," *Survey of Current Business*, November 1957, pp. 18-19.

<sup>29</sup> J. H. Lorie, "Two Important Problems in Sales Forecasting," *The Journal of Business*, Vol. 30, No. 3 (July 1957), p. 174.

also describe the equation for forecasting aluminum demand that we looked at earlier?" You are right. Forecasting equations derived through correlation analysis techniques are, in fact, econometric models, but there are many kinds of econometric models and some, as we shall soon illustrate, do not depend entirely on correlation analysis for their construction. Broadly defined, an econometric model is nothing more than a simplified abstraction of a real economic situation, expressed in equation form, and employed as a prediction system that will yield numerical results.<sup>30</sup> The basic demand or sales equation for a consumers' durable good, for example, may be written as follows: <sup>31</sup>

$$S = R + N$$

Where: S represents total sales of the good

R is replacement demand—i.e., purchases made to replace units of the good going out of service, as measured by the scrappage of old units

N is new-owner demand—i.e., purchases made not to replace existing units of the product, but to add to the total stock of the product in consumers' hands

Now what does this equation say? First, it expresses the truism that total sales are equal to total purchases. Second, it says that total sales of a durable consumer product during some period are made up of purchases by new owners and of purchases made to replace old units which have been scrapped. Thus, a family buys its first new automatic washing machine and becomes a part of the new-owner demand for that machine; another family that has a five-year-old machine trades it to a dealer for a new machine and becomes part of the replacement demand (though only effectively so when the five-year-old machine, perhaps passing through several families' hands in the process, finally comes to be owned by a family which goes ahead and consigns its even older machine to the scrap heap).

Replacement demand, then, is normally measured by the scrappage of old units of products—i.e., by the percentage of the total stock of the product in consumers' hands that is actually taken out of service either through consignment to the trash pile, by sale to a junk dealer, or merely by being stowed away and never used again. So replacement demand in any one year does not necessarily include demand originating from the family that had a five-year-old machine which it traded to a dealer for

<sup>30</sup> M. H. Spencer and L. Siegelman, *Managerial Economics* (Homewood, Ill.: Richard D. Irwin, 1959), p. 40.

<sup>31</sup> *Ibid.*, p. 174.

a new machine, with the dealer reselling the old machine to another family who buys it second-hand. Only when the particular washing machine involved goes *completely out of service* is it considered as having been scrapped and, at that time (through a chain reaction of purchases and trade-ins), some family becomes a part of the replacement demand. Econometricians estimate replacement demand by using life expectancy tables or survival tables, which are similar to the life (or mortality) tables used by life insurance actuaries. An example of such a survival table is shown in Exhibit 14.1.

**Exhibit 14.1****Durable Goods Survival Coefficients**

Maximum Service Life: 11 years

Average Service Life:  $6\frac{1}{2}$  years

<i>Year</i>	<i>Survival Coefficient</i>
1	1.0000
2	.9995
3	.9946
4	.9656
5	.8621
6	.6406
7	.3594
8	.1379
9	.0344
10	.0054
11	.0000

Source: M. Spencer, C. Clark, and P. Hogue, *Business and Economic Forecasting* (Homewood, Ill.: Richard D. Irwin, 1961), p. 256.

If some durable consumer good has a maximum service life of 11 years and 10,000 machines enter service in some year, the table tells us that five years later 8,621 will probably still be in service and ten years later 54. For this batch of 10,000 machines, scrappage would amount to 1,035 in the fifth year (i.e.,  $1,379 - 344$ , the difference between the accumulated total scrappage at the close of the fifth and fourth years respectively). In the fifth year, then, 1,035 replacement sales would trace back to the batch of 10,000 machines that had entered service five years before.

In this model, new-owner demand is defined as the net addition to consumer stocks of the product which occurs during a given period. For instance, if 2,000,000 units of some appliance were in service at the start of a period and 2,500,000 at the end, new-owner demand would have been 500,000 during the period. Forecasting the number of sales to new owners is a matter of treating the stock of a durable good in the hands of consumers as a "population" exhibiting both "birth" and "death" character-

istics—i.e., thinking of this stock as behaving in ways roughly analogous to a human population. This analogy makes possible the following axiom:<sup>82</sup>

At any given time there exists in the economy a set of economic and cultural conditions which, in combination, determine a maximum limit toward which consumers are continually adjusting their stock of a durable good.

This maximum limit is called the "maximum ownership level," which is, of course, determined by interactions of economic and other uncontrollables. Because we are treating the stock of the durable good in consumers' hands as a population, such demographic factors as the number of families affect the maximum ownership level. This level is also affected by the economic uncontrollable "consumer purchasing power," as measured by some weighted combination of disposable personal income, availability and cost of credit (because we are talking about durable goods), and prices of the product and its substitutes. Finally, maximum ownership level is affected by what econometricians call a "replacement factor," such as measured by a ratio of the price index of the product to an index of its durability (the latter index being based on the average age of the durable good at its retirement).<sup>83</sup> In other words, the replacement factor is included because a consumer's decision to replace a unit now in service depends both on how much money replacement costs and on the average amount of time it takes for the product to wear out.

Constructing this type of econometric model involves going through a three-step procedure. First, the various uncontrollables affecting each demand category (i.e., replacement and new-owner) are scrutinized and those particular uncontrollables that bear some logical relationship to sales (as the dependent variable) are chosen for correlation analysis. Second, the forecaster detects (through correlation analysis) that combination of uncontrollables which correlates best with sales and, sometimes, he includes a time trend in this combination (to represent other uncontrollables that cannot be measured directly). Third, he chooses a suitable mathematical expression to show the quantitative relationships among the various independent variables (i.e., uncontrollables) and the dependent variable (i.e., sales).<sup>84</sup> This expression becomes, then, the econometric model which is used for sales forecasting.

The general procedure for building econometric models seems relatively simple, but such models, when actually constructed, can take on rather

<sup>82</sup> M. H. Spencer and T. Mattheis, "Forecasting Sales of Consumers' Durable Goods," *California Management Review*, Vol. 4, No. 3 (Spring 1962), p. 79.

<sup>83</sup> *Ibid.*, p. 79.

<sup>84</sup> H. Anderson, "Scientific Sales Forecasting and its Problems," *Economics and Business Bulletin*, Vol. 15, No. 2 (December 1962), Temple University School of Business and Public Administration, pp. 18-20.

formidable appearances. Consider, for example, the following econometric model for forecasting the sales of washing machines.<sup>35</sup>

$$S_{tc} = Y_t - y_t + Y_t \left\{ H_t \left[ .03 - .0157 \left( \frac{I_t + 3C_t}{P_t} \right) \right] - .0000283Y_t \right\}$$

Where:  $S_{tc}$  is the calculated value for forecasted sales of washing machines during some time period

$Y_t$  is the level of consumers' stock of washing machines in any period (as of Jan. 1)

$y_t$  is the level of consumers' stock that would occur in the following period (as of Jan. 1) if no washing machines were sold and scrappage rates remained the same

$H_t$  is the number of wired (i.e., electrified) dwelling units in millions

$I_t$  is disposable personal income

$C_t$  is net credit extended (excluding credit extended for automobiles)

$P_t$  is the price index for house furnishings

$10.01818t - 33.1143$  is the trend of real purchasing power over time and

$\frac{I_t + 3C_t}{P_t}$  represents real purchasing power

Thus, new-owner demand in this model is represented by  $Y_t - y_t$ , both members of the expression being determined through application of appropriate survival coefficients to previous years' sales of washing machines, and through estimation of consumers' total stocks of washing machines in each year. Replacement demand is represented by the other symbols in the remaining part of the expression, which takes into account the number of wired dwelling units (washing machines are not likely to be sold to people who live in homes with no electricity), real purchasing power (disposable personal income plus credit availability divided by a price index), and real purchasing power adjusted for the historical trend of real purchasing power over time. Correlation analysis techniques were used to derive the various numerical values in this model.

The econometric model-building approach seems a near-ideal way to forecast sales. Not only does it take into account the interaction of various uncontrollables that bear logical and measurable relationships to sales, it also uses correlation analysis techniques to quantify these relationships.

<sup>35</sup> Spencer and Mattheis, *op. cit.*, p. 98.



To date, however, very little use has been made of such models in forecasting the sales of individual companies, but numerous efforts have been made to use them for forecasting industry sales.<sup>36</sup> This is because the uncontrollables affecting a specific company's sales are more numerous and more difficult to measure than those determining the sales of a whole industry. This suggests that it would be reasonable to use an econometric model to forecast industry sales, and then to apply some estimate of the firm's share-of-the-market percentage to the industry forecast to arrive at the company's sales forecast. Such a model representing an industry's demand function can be very helpful to the forecaster, especially when a company's share-of-the-market is either very stable or relatively easy to predict for other reasons.<sup>37</sup> Probably the main thing blocking widespread adoption of the econometric model-building approach to sales forecasting is that it requires more complete information on a company's (or industry's) marketing situation than do less sophisticated approaches. As more and more companies acquire more adequate marketing research programs, much larger amounts of the needed information will be made available to forecasters. We can, therefore, look forward to having an increasing number of sales forecasts developed through the econometric model-building approach.

#### ***Breaking Down the Forecast***

The sequence of forecasting procedure usually provides, first, for making an industry sales forecast and, second, for breaking down this forecast into a company sales forecast. Our previous discussion reflects the fact that this is the usual sequence—we examined four main forecasting approaches, and only the poll of sales force opinion (the most unsophisticated approach) skips the industry sales forecast and goes directly to a company sales forecast. The other three approaches—survey of buying plans, correlation analysis, and econometric model-building—usually result in industry sales forecasts which, of course, measure the extent of sales opportunities available to all competitors in an industry. Transforming an industry sales forecast into a company sales forecast requires that company strengths and weaknesses relative to those of competitors be appraised and a quantitative estimate of the company's share-of-the-market be arrived at, which estimate can then be used for deriving the company sales forecast. Notice that the poll-of-sales-force-opinion approach leaves this appraisal of competitive strengths and weaknesses largely up to the salesmen—they concentrate on estimating how much the company can sell, not how much the industry can sell. In the other

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<sup>36</sup> C. M. Crawford, *Sales Forecasting: Methods of Selected Firms* (Urbana, Ill.: University of Illinois, 1955), p. 46.

<sup>37</sup> *Ibid.*, p. 46.

three approaches, management makes this appraisal at the time it determines the company's probable share-of-the-market percentage and, although some companies check such estimates with their salesmen, the main appraisal of competitive position is made by executives who should be better informed on the over-all sales outlook than any salesman can possibly be.

Forecasting a company's future market share is a problem which varies greatly in its complexity from industry to industry. At one extreme, we have such industries as steel and lumber, where a few large producers dominate the industry, and market share relationships among competitors are fairly stable from year to year. In such industries, forecasting a company's market share is largely a matter of projecting past trends. For example, if a steel producer currently has a 15 per cent market share, and if in recent years its market share has risen by one per cent a year, the forecaster might simply extend this trend and predict that next year's market share will be 16 per cent. Such extensions of market share trends are safest in those industrial marketing situations where products are highly standardized, price changes by one industry member are immediately met by all competitors, and there are comparatively small numbers of buyers all of whom are well-informed. These are conditions conducive to stabilizing market share relationships among an industry's competitors. Oxenfeldt points out that when market shares change very slowly in an industry, strong forces must be present which tend to perpetuate the existing apportionment—including such forces as close buyer-seller relationships and buyers' possession of supplies and repair parts suitable for use with only one competitor's make of the product.<sup>38</sup> He also points out that in consumer goods marketing situations, such forces include the belief that one gets on a given brand a higher trade-in value than on any other brand and, simply, irrational brand loyalty based on familiarity, perhaps mixed with the desire for security in using what is known and tried.<sup>39</sup>

At the other extreme we have industries where it is extremely difficult to predict relative market shares of different competitors from one year to the next—e.g., women's clothing. As one prominent forecaster says, "the number of women who will wear clothes at a given time can be accurately forecast, but *what* they will wear is problematical at best."<sup>40</sup> And "what women will wear" depends on such things as fashion, prices, relative effectiveness of different competitors' advertising and sales pro-

<sup>38</sup> A. R. Oxenfeldt, "How to Use Market-Share Measurement," *Harvard Business Review*, Vol. 37, No. 1 (January-February 1959), p. 67.

<sup>39</sup> *Ibid.*, p. 67.

<sup>40</sup> S. Teitelman, "The Place for Assumptions and Judgments in Sales Forecasting," in *Aspects of Modern Marketing* (New York: American Management Association, 1958), Management Report No. 15, p. 33.

motional programs, and dealers' enthusiasm in selling each manufacturer's product. In such style-goods industries, the ability to evaluate a style's salability is a key element in forecasting, and this requires both thorough knowledge of the market and unerring judgment. One year an apparel manufacturer may offer a design that catches on immediately and becomes a great success: the next year his offering may turn out to be a "dud," his market share virtually disappearing.

However, since most companies operate in industries somewhere between these two extremes—with market shares neither as stable as in steel nor as volatile as in women's apparel—forecasters in most companies need information on competitors' price policies, advertising and selling plans, plans to launch new and improved products, and so on. When a forecaster evaluates such information in relation to his own company's proposed marketing plan, he is in a position to exercise informed judgment in predicting his company's probable market share. If, for example, a forecaster knows that a major competitor plans a substantial price cut on a product which many consumers buy mainly on the basis of price, he will have to lower his estimate of the company's predicted market share accordingly unless management is willing to match the price cut. Forecasting a particular company's market share is a matter both of examining past trends and of appraising significant changes in competitive relationships which may alter these past trends.<sup>41</sup>

Once a company sales forecast is obtained, it is necessary to break it down into smaller units in order to improve its usefulness for purposes of planning and control. One of these finer breakdowns involves the deriving of sales forecasts by individual products or product lines. How this is done depends chiefly on the forecasting approach used. Since most companies operate in more than one industry, we believe that the preferred approach should be first to develop sales forecasts for each industry, and then apply estimated market-share percentages for each product or product line in each industry in order to arrive at individual product sales forecasts. General Motors, for instance, operates not only in the automobile industry but also in kitchen appliances through Frigidaire and a number of other lines; necessarily, more than one industry sales forecast has to be made in arriving at a forecast for General Motors. Thus, individual product forecasts generally are derived from separate industry sales forecasts, which makes this particular breakdown in companies following our recommended forecasting procedure not so much a breakdown as a building up of the company sales forecast by combining several individual product forecasts.

The poll-of-sales-force-opinion approach, you will remember, usually

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<sup>41</sup> For a suggested method of using econometric analysis for the purpose of projecting market share trends, see: Anderson, *op. cit.*, p. 22.

skips making an industry sales forecast, and its users, consequently, have a unique problem in breaking down the over-all forecast into individual product forecasts. Since this approach does not provide for forecasting industry sales at the salesmen's level, whatever consideration is given to the company's sales in relation to the sales of the industries in which it is engaged must take place at higher organization levels. A good case in point is the Cherry-Burrell Corporation, which makes and markets broad lines of processing equipment and material-handling machinery for the dairy, beverage, brewery, chemical, and food-processing industries as well as certain specialized pieces of farm equipment. This company starts its forecasting procedure with individual salesmen's estimates of sales by individual products to specific industries; next, branch sales managers adjust salesmen's estimates according to their experience and specialized knowledge; these figures are then consolidated for the company as a whole, at which stage the "preliminary forecast" is delivered to the controller and marketing research manager who adjust the grand total in line with their evaluations of the general economic outlook and changes in the outlook for each of the 74 individual product-line categories. A Cherry-Burrell executive explains how these product-line forecasts, which have their origins in salesmen's estimates, are adjusted:<sup>42</sup>

There is no adequate set of rules to follow. We know we must have a reasonable total and that this total is the sum of the 74 individual product-line categories. We cannot do too great violence to the total, nor can we arbitrarily assign unreasonable amounts to the individual items. We re-examine each product line with greater care and an even more stony eye, always keeping in mind such factors as competitive pricing, special promotions by ourselves or others, new developments in the industry which might affect sales of specific products, availability of materials or manufacturing facilities, increased or decreased sales department emphasis on certain lines, relative degree of market saturation, and whatever other information might be pertinent.

Another important breakdown of the company sales forecast is that by individual geographic areas, such as by sales territories. In making this breakdown, management is, in effect, answering the question "Where should we make how many sales?" In other words, the problem now is to allocate the company's total sales-making opportunities among the various territories in which it operates. How can such geographical allocations of sales-making opportunities be made? One approach is to calculate each area's historical percentage of total company sales, adjust these calculations according to each area's historical sales growth trend, "juggle" the resulting percentages so they sum to 100 per cent, and apply

<sup>42</sup> F. A. Lackner, Jr., "Forecasting for a Variety of Products," in *Materials and Methods of Sales Forecasting*, pp. 164-165.

the final percentage values to the company sales forecast, arriving in this way at territorial sales forecasts. Although this approach has the advantage of being simple and relatively easy to apply, it suffers from the built-in assumptions that past trends in the geographical distribution of sales will continue and that this distribution is satisfactory. Thus, the historical approach ignores the possibility that shifts in the geographical spread of salesmaking opportunities may occur and, furthermore, that such shifts may be desirable; (e.g., if some market area, such as California, is growing very rapidly, it may be desirable to allocate to that area much more than its historical share of total company's sales.)

A different and somewhat more promising approach to the problem of obtaining individual territorial forecasts is to concentrate on the factors that influence sales-making opportunities (e.g., such factors as population and disposable personal income), analyzing how the impacts of these factors are distributed geographically, and allocating the total sales forecast among different territories according to the proportional sales-making opportunity present in each (measured according to the factors influencing sales-making opportunities). This approach shifts the emphasis away from historical sales experience and toward the factors which affect the opportunities to make *future* sales. Using this approach requires preparation of an index representing the combined impact of the different factors influencing sales-making opportunity, and application of this index to the company sales forecast; this results in sales forecasts for individual territories. The index chosen can be a single-factor type, such as the population in each sales territory; here, the index value representing a territory with 1,000,000 population would be twice that of a territory with 500,000 population. Notice, in this example, that the single-factor index method assumes that the distribution of population is directly proportional to the distribution of sales-making opportunity which, of course, is something that may or may not be true. The alternative is to use a multiple-factor index, which is an index that "weights" the impacts of such factors as population and disposable personal income. Notice that in constructing a multiple-factor index, some weight must be assigned to the relative impact each factor has on sales. Such assignments may be made arbitrarily (i.e., purely according to management's judgment as, for example, "income is twice as important as population") or through the techniques of multiple correlation (i.e., by correlating sales with such independent variables as population, income, number of wired homes, and so on).<sup>43</sup> But no matter how the index is determined, applying it to individual territories provides only a tentative allocation of the

<sup>43</sup> For an excellent discussion of various index methods and their applications to determining territorial sales forecasts, see: D. M. Phelps and J. H. Westing, *Marketing Management*, rev. ed. (Homewood, Ill.: Richard D. Irwin, 1960), pp. 249-264.

company sales forecast. This tentative allocation must then be adjusted according to factors not included in the index, such as territorial differences in competitive strength, and differences in individual salesmen's effectiveness. These adjustments are necessary because, even though the index may indicate that a given amount of sales-making opportunity is present in a territory, such factors as the presence of a strong local competitor may make this amount unattainable while other conditions such as an unusually capable salesman assigned to the territory may mean that the indicated amount can be easily surpassed. It should be clear, then, that putting territorial sales forecasts into final form requires not only judgment but considerable knowledge of territorial conditions. For this reason, many companies "check out" the tentative allocations to territories with the salesmen involved.

#### *Derivation of a Sales Volume Goal*

A sales volume goal for the coming operating period is the hoped-for outcome of a company's short-range sales forecasting procedure. In order to understand the relationship of the sales volume goal and the sales forecast, we must recall the two main parts of our definition for a sales forecast: (1) it contains an estimate of sales tied to a proposed marketing plan, and (2) it assumes a particular set of uncontrollable and competitive forces. This estimate of sales does not necessarily and automatically become the company's sales volume goal, but it does provide an orienting point for management's thinking. Further adjustments in this estimate are usually necessary, both because it takes considerable time to prepare a sales forecast and because the forecasters are not in constant touch with management. For instance, during the time a forecast is in preparation, changes in uncontrollable and competitive forces can occur, and these may be important enough to now call for a revision in the sales estimate; such revisions, of course, may be either upward or downward. Similarly, there may have been changes in the way the company now intends to manipulate its controllables (i.e., in its marketing plan), and these changes, too, may indicate a need for adjusting the sales estimate. And, similarly, the sales forecast may have uncovered sales opportunities not recognized in drafting the initial proposed marketing plan, and this may require adjustment of the sales estimate, the proposed marketing plan, or both.

The sales volume goal finally established (after the above adjustments have been made) should be consistent with both management's profit aspirations and the company's marketing capabilities. In other words, it must be attainable at costs low enough to permit the company to earn a net profit considered satisfactory by management, and for the company's marketing forces (i.e., its sales force, the advertising program,

the dealer organization, and so on) to be capable of reaching the set goal. All three of these important items—the sales volume goal, management's profit aspirations, and the company's marketing capabilities—are inter-related. Using the sales estimate in the sales forecast as a point of departure, management juggles these three items until it satisfies itself that the relationship between them is the best that can be obtained. Only then can we say that the sales forecast has resulted in the establishment of a sales volume goal. And at that time, the chief marketing executive accepts the major responsibility for making the forecast "come true." Marketing policies and selling strategies, formulated by him and his subordinates, must be put into effect in the grand effort to reach the sales volume, profit, and other objectives derived from the sales forecast. Thus, these final adjustments involved in converting the sales estimate in the sales forecast into a sales volume objective are of vital concern to marketing management.

#### *Evaluation of Forecasts*

Before he submits the forecast to top-management for approval, the marketing executive (whether he personally has made the forecast or has delegated the job to someone else) is responsible for evaluating it. Since every forecast necessarily pertains to the future, all forecasts contain some element of uncertainty; consequently, all forecasts are based on assumptions. So a good first step in evaluating any sales forecast is to examine the assumptions on which it is based. Any good forecast should include a forthright statement of its underlying assumptions. The marketing executive should also look for any hidden assumptions (ones the forecaster has unconsciously built into the forecast); he should view each and every assumption in a critical light and note particularly any that seem unwarranted, testing each by asking "if this assumption were removed, or changed, how would the resulting forecast be affected?" Beyond checking the assumptions, the marketing executive should evaluate the forecasting methods as objectively as possible, and do his best not to become hypnotized by the impressive appearance of a "finished" forecast. He should also compare the forecast with his own specialized knowledge of (and feel for) the company's marketing situation, conditions in the industry, and the general economic outlook.

Throughout his evaluation, the marketing executive should be alert for any errors, asking himself such questions as these:

1. Are there any variations here from what past experience would seem to indicate? (For example, is the projected share-of-the-market fairly consistent with the company's historical market share?)
2. Is the estimate of sales stated both in dollars and in units of product? (Both are needed—the treasurer, for instance, will be interested in the



dollar estimate, while the production manager will be interested in the estimate in units of product).

3. Does the forecast rely too heavily on trade association data? (Many trade associations report such statistics as sales and production figures for the "industry" but, almost always, some industry members do not report, which results in data for only part of the industry. If such data are used for forecasting purposes, they must be adjusted to take into account the operations of non-reporting industry members.)
4. Has the forecaster considered any new competitive products? (For example, in forecasting the sales of room air conditioners, one must also consider the sales growth rate of heat pumps—a competing product that both heats and cools and one that seems certain to cut into the sales of other types of air conditioning units.)
5. Has the forecaster considered inventory movements at all distribution levels? (Suppose, for example, that a consumer goods manufacturer uses both wholesalers and retailers in his distribution channel. Such a manufacturer should not necessarily assume that he will sell the same number of units of product as consumers will buy during the period. If middlemen have large inventories of his product on hand, his sales may well be less than the number consumers actually buy. However, if the middlemen have small inventories, his sales could be larger than the amount consumers actually buy—i.e., some of the units he sells will go into middlemen's build-ups of inventories.)

The marketing executive must also concern himself with the continuing task of appraising sales forecasts against the criteria of accuracy and economic value. The assessment of a sales forecast's accuracy is something that cannot be done in advance; it has to be done by hindsight. When the period's sales results are all recorded, they should be compared with the forecast's predicted results and variations should be explained and recorded for possible future use in improving forecasting accuracy. The executive should, therefore, insist that the forecast be checked against actual results and that variations be explained; that is the only way to assure that the forecast will fully serve its purpose as a control device; and such insistence also forces the forecaster to continually check the assumptions underlying forecasts. Appraising a sales forecast for its economic value is also something that can be done only after the sales results are in. A sales forecast has economic value if decisions based on it are more profitable than they would be if based on such other grounds as past experience or pure executive intuition. Accuracy and economic value in sales forecasts, then, go together—forecasts with higher degrees of accuracy also have higher economic value. But high accuracy should not be secured at too high a price. A forecast, in other words, can "cost more than it is worth," which means



that it is possible for a forecast's accuracy to involve such high research costs that its economic value is negated.

#### **FORECASTING SALES OF NEW PRODUCTS**

Forecasting sales for a new product poses a different set of problems than those which arise in forecasting sales of established products. In making a new-product sales forecast, for example, it is not very helpful to poll the salesmen on whether they think the new product will sell and, if so, in what quantities; some salesmen may be competent judges of the salability of a new product, but there is no reason to believe that they are more competent than marketing executives, who should have access to more information. It is, of course, possible to survey potential consumers regarding their willingness to buy a new product, but this is not usually very practical unless consumers have actually seen the product and, perhaps, sampled it—and, even then, there are usually discrepancies between what consumers say they will buy and what they actually do buy. Similarly, such sophisticated approaches as correlation analysis and econometric model-building are difficult to apply to new-product forecasting since there are no historical data to analyze. Thus, compared to forecasting sales of an established product, forecasting sales of a new product is characterized by a much higher degree of uncertainty; many more assumptions are necessary to formulate the sales estimate than are needed for making a forecast for an established product.<sup>44</sup>

One approach to new-product sales forecasting (called the “evolutionary” approach) involves making the crucial assumption that potential buyers will consider the new product a new version of some existing product. In forecasting sales for a cordless electric shaver, one might assume that it is merely an improvement of the older, cord-type electric shaver. The forecasting procedure, then, could consist of projecting the evolving pattern of sales for the older product. This approach, as you might expect, is appropriate only when it is highly probable that buyers will consider the new product just an improved version of some existing product.

A second approach, almost like the evolutionary approach, involves making the crucial assumption that potential buyers will consider the new product a *substitute* for some established product or products. (This approach, not surprisingly, is called the “substitute approach.”) Take paper napkins for example; when first introduced, they could properly have been considered as substitutes for linen and other fabric napkins (and, interestingly enough, this was also the theme used in the

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<sup>44</sup> On this point, see: J. F. Bahm, Jr., “Sales Forecasting for New Products,” in *Sales Forecasting: Uses, Techniques, and Trends*, p. 76.

initial promotion of paper napkins). The assumption in this approach, then, is that the new product will serve the same *purposes* that older products now serve. The forecaster using the substitute approach tries to determine how much demand exists (and is likely to develop) for products to serve the purposes involved and attempts to determine the rate at which the new substitute product will displace the old product. Setting up the forecasting problem in terms of uncovering the different forces which determine the *rate of displacement* also directs attention to "what needs to be done to improve, promote, or price the new product for faster encroachment."<sup>45</sup> In making his analysis, then, the forecaster should compare the new product with those it substitutes for on such bases as the extent to which potential buyers are likely to consider it a highly significant improvement, the nature and types of promotion needed to displace the older products at different rates, and the effect of the proposed price in relation to speeding up or slowing down the rate of displacement.

A third approach to new-product sales forecasting uses market testing to obtain information useful for projecting the probable demand for the new product. Putting the new product on sale in a local market, the manufacturer attempts not only to secure qualitative information on the product's acceptability to the market but such important quantitative data as the proportion of potential buyers who actually buy, the number of "triers" who buy the product a second time, and the time interval that elapses between first and second purchases. In market testing a new detergent, for example, the marketer might find that 25 per cent of the second-time buyers bought the product again within six weeks' time. From such data, he would probably be able to construct a national sales forecast for the new detergent.<sup>46</sup> The relevance of such test market data for projection (i.e., forecasting) purposes, however, depends on the extent to which marketing conditions in the test market simulate those that will be met when full-scale marketing is undertaken, for this approach's crucial assumption is that similar marketing conditions exist in both the test and national market. Although it is possible to find local markets where the nature and makeup of the consuming public are substantially similar to the national market (e.g., both Syracuse, New York, and Dayton, Ohio) it is hardly ever possible to replicate

<sup>45</sup> Dean, *op. cit.*, p. 174.

<sup>46</sup> Several writers have explained methods for using data gathered through market testing in predicting the success of new products and in forecasting their sales. For instance, see: L. A. Fourt and J. W. Woodlock, "Early Prediction of Market Success for New Grocery Products," *Journal of Marketing*, Vol. 25, No. 2 (October 1960), pp. 31-38; W. D. Barclay, "A Probability Model for Early Prediction of New Product Market Success," *Journal of Marketing*, Vol. 27, No. 1 (January 1963), pp. 63-68; and B. Lipstein, "Tests for Test Marketing," *Harvard Business Review*, Vol. 39, No. 2 (March-April 1961), pp. 74-77.

the accompanying marketing program exactly. For example, advertising in the test market may have to be mainly through newspapers and local television, while the full-scale marketing program may contemplate extensive use of magazines and network television. In spite of these imperfections, however, market testing is widely used to gather quantitative data for use in forecasting new-product sales, especially by manufacturers of such low-priced products as soap, food items, and drugs and cosmetics.

The market-testing approach to sales forecasting is also used with higher-priced new products which are radically different from established products that serve the same purposes. The B. F. Goodrich Company, for instance, in 1947, developed the first tubeless tire, a truly revolutionary development inasmuch as automobile owners previously had regarded the inner tube as a necessary and vital part of the tire and tube combination. Since the tubeless tire changed the basic concept of what a tire was, Goodrich decided to market test the new product. In the words of Goodrich's director of business research:<sup>47</sup>

We realized that nothing was known about the public's reaction to such a revolutionary product. Therefore, we decided to test market the tubeless tire in the belief that there might be some highly important facts to be learned before we spent millions trying to market it from coast to coast.

From the market testing (in Cincinnati, Ohio), Goodrich obtained quantitative data which were used not only to project the level of probable national demand but also in making related important decisions on pricing, advertising, and the training of dealers' sales and service personnel. This example serves, also, to point up another feature of the market-testing approach: it is most feasible in rather advanced stages in the technical development of a new product. In such cases, too, the market-testing approach may be the only way to gather data which is unobtainable through either the evolutionary or substitute approaches. There is no question, however, that market testing involves much larger expenditures than are incurred through use of the evolutionary and substitute approaches. Management, therefore, in deciding on the particular approach (or approaches) to use for new-product sales forecasting, must weigh the relative research expenditures against the probable value of the resulting data.

<sup>47</sup> D. E. Carson, "Test Marketing the B. F. Goodrich Tubeless Tire," in *Marketing Research in Action* (New York: National Industrial Conference Board, Inc., 1957), Studies in Business Policy No. 84, p. 53.

### CONCLUSION

The sales forecast provides information which management uses in setting the sales volume goal—the business objective that

occupies a most strategic place in both marketing and non-marketing planning. The preliminary analysis and work leading up to the sales forecast is, itself, an extremely important form of planning, and essentially involves securing a satisfactory three-way adjustment of sales-making opportunities, profit objectives, and marketing capabilities. The finished sales forecast becomes, in essence, management's official prediction of the consequences which should follow from the implementation of a series of inter-related marketing and non-marketing decisions. Marketing management plays a key role not only in implementing these decisions but in sales forecasting. Although the marketing executive does not have to be a technical expert on every phase of forecasting, he is responsible for being well enough informed to be able to help the forecasting group solve the various problems encountered. In order to effectively discharge this important responsibility, the marketing executive must not only keep abreast of current developments in the company's marketing situation and the surrounding competitive environment, he must also be able to assess both his firm's marketing capabilities and ideas concerning the likely course of future events. Possessing this knowledge, the marketing executive must also have the background needed for discharging another of his important forecasting responsibilities—that of appraising the worth of individual forecasts and the economic value of the total sales forecasting program.

#### QUESTIONS AND PROBLEMS

1. Outline the steps involved in marketing planning, and explain how sales volume goals are established.
2. Compare and contrast short-range and long-range sales forecasts, and analyze the relationship of each type of forecast to marketing decision-making.
3. Construct a diagram to illustrate the interrelationships of the following items in a company's round of short-range planning activities: sales estimate, sales volume goal, marketing plan, production schedule, manpower needs estimate, purchase schedule, projected cash inflow, projected cash outlay, and the financial plan.
4. What stakes does marketing management have in short-range sales forecasting? In long-range sales forecasting?
5. What points would you want to investigate in the course of evaluating the procedure a company uses for obtaining its short-range sales forecast?

6. What are the forms of inter-industry competition? What is the significance of each form to the sales forecaster?
7. Give a few examples of psychological and sociological uncontrollables that might affect the general economic outlook. How might these same uncontrollables influence industry and company selling opportunities?
8. What criteria are ordinarily used in reducing to a manageable few the number of uncontrollables used in forecasting sales?
9. For each product included in the first list below, select one or more uncontrollables from the second list which you believe would be most helpful in forecasting the product's sales:

<i>Products</i>	<i>Uncontrollables</i>
Bermuda shorts	Age composition of the population
Bicycles	Business expansion plans
Breakfast cereals	Consumers' disposable income
Cement	Consumers' propensities to save and to consume
Cigarettes	Credit availability and interest rates
Electronic computers	Educational level
European travel	Employment
Extension telephones	Fashion
Household appliances	Geographical distribution of population
Infants' clothing	Government spending and taxation
Pharmaceuticals	Gross national product
Playing cards	Home ownership
Roofing materials	Industry and anti-industry propaganda
Swiss watches	Inter-industry competition
Tape recorders	Leisure time
Textbooks	Private investment expenditures
Virgin Islands rum	Public attitudes on chances of war or peace
Work shoes	Types and sizes of families

10. Are the following statements true or false? Justify your answer in each instance.
  - a. The main task of the forecaster is to minimize the uncertainty affecting current decisions.

- b. It should be very rare for a sales forecast to be based on no more than a guess.
  - c. The closer the forecaster comes to predicting sales for a specific product of a specific company, the larger the margin of error is likely to be.
  - d. Sales forecasts motivate the planning process so that the planners have sufficient lead time to plan with maximum efficiency.
  - e. Practically every marketing decision implies some forecast of the enterprise's future.
11. Evaluate the general truth of each of the following statements.
- a. "The salesman who knows his customers' business and can talk about that business in his customers' language, can tell management pretty accurately what the demand will be—even what his own sales will be."
  - b. "I admit my company's sales forecast is based on intuition, and no one is more unhappy about this than I am. But if I were clairvoyant, I would not be in this business but would be following the ponies instead."
  - c. "When a company depends upon its salesmen to do the sales forecasting, a great deal of money is lost because of the poor forecasts that are produced. Sales are lost because of out-of-stock situations. Certain sales turn out to be profitless, because overtime wage rates have to be paid in order to fill customers' orders. Inventories sometimes balloon out of all proportion to the inflow of orders tying up working capital and, in some cases, outright losses result because of product obsolescence."
12. Industrial marketers use surveys of customers' buying plans as a sales forecasting approach to a much greater extent than consumer goods marketers. Why?
13. Identify the main assumptions underlying each of the following sales forecasting approaches:
- a. poll of sales force opinion
  - b. survey of customers' buying plans
  - c. correlation analysis
14. Explain the meaning of each of the following terms:
- a. econometric model
  - b. dependent variable
  - c. independent variable
  - d. lead-lag relationship
  - e. replacement demand
  - f. new-owner demand
  - g. survival coefficient
  - h. maximum ownership level

15. Explain how correlation analysis and econometric model-building are related.
16. Why have econometric models (to date at least) been more used for forecasting industry sales than for forecasting sales of individual firms?
17. To which, if any, of the following companies would you recommend the use of the "prudent-manager" forecasting approach? State your reasoning in each case.
  - a. A manufacturer of diesel railway engines
  - b. A producer of airport lighting equipment
  - c. A local Cadillac dealer
  - d. A producer of industrial lubricants
  - e. An importer of Oriental rugs
  - f. A typewriter manufacturer
  - g. A life insurance company
18. Refer to Exhibit 14.1 (p. 367), and assume that a certain durable consumer good has a maximum service life of 11 years and that 10,000 units of the good enter service in some year.
  - a. How many replacement sales that trace back to the original batch of 10,000 units will be made in the fourth year?
  - b. How many replacement sales that trace back to the original batch of 10,000 units will be made in the ninth year?
19. What is the rationale for making an industry sales forecast before developing the sales forecast for an individual company?
20. Under what conditions is it fairly safe to extend trends in market shares in arriving at a forecast of a particular company's market share? Under what conditions is such trend extension dangerous?
21. Construct a check list that a marketing executive might find useful in evaluating sales forecasts before he submits them to top-management for approval.
22. Compare and contrast the problems encountered in forecasting sales of established products with those encountered in forecasting sales of new products.
23. Evaluate the relative merits of the evolutionary, substitute, and market-testing approaches to new product sales forecasting.

24. How can an executive tell whether a given sales forecast has accuracy and economic value?
25. Company A's product, a small household appliance, is sold through a sales force of 15 men to appliance dealers throughout the entire country. Price competition is not serious, and the wholesale and retail prices of A's product are comparable to those of competitors. Study the figures in the exhibit below and answer the questions that follow.

<i>Year</i>	<i>Industry Unit Sales</i>	<i>Company A Unit Sales</i>	<i>A's Advertising Expendi- tures as % of Industry</i>	<i>A's Net Profit as % of A's Sales</i>	<i>Size of A's Sales Force</i>
1	1,000,000	40,000	5%	10%	12
2	1,250,000	45,000	5	10	11
3	1,400,000	60,000	5	11	13
4	1,590,000	55,000	5	9	14
5	1,700,000	70,000	5	9	15
6	1,900,000	85,000	6	10	14
7	2,200,000	110,000	6	11	14
8	2,300,000	120,000	6	12	13
9	2,350,000	125,000	6	12	15
10	2,500,000	130,000	7	10	15

- a. After studying such uncontrollables as consumers' disposable income, family formation, and employment, the sales forecaster estimates industry unit sales in Year 11 will amount to 2,550,000 units. Assuming no change in A's advertising expenditures relative to the industry total and no change in the size or efficiency of A's sales force, what should be the forecast of A's sales for Year 11?
- b. Supposing Company A decides to increase its advertising expenditures to 10 per cent of the industry total and to add five men to the sales force. Would this additional information cause you to revise the forecast of A's sales for Year 11? How?
- c. Suppose Company A's top management sets 12 per cent as its "target" net profit percentage on sales for Year 11. As the marketing manager of Company A, what would be your reaction to the announcement of this target? Why? Outline your next moves and their sequence.





## **PART FOUR**

# **Areas of Decision**

**ORGANIZATION**

**THE PRODUCT**

**DISTRIBUTION POLICIES AND PHYSICAL DISTRIBUTION**

**PRICING**

**ADVERTISING**

**MANAGEMENT OF PERSONAL SELLING**

**MARKETING STRATEGY**

## ORGANIZATION

# 15

In this part of the book (Part Four), we consider the controllable forces in marketing—those forces which can be directly influenced by decisions and actions of the individual firm. Through making and implementing decisions on such controllables as marketing organization, products, brands, prices, distribution channels, physical distribution, advertising, promotion, and personal selling, marketing management seeks to adapt the firm's operations to an environment made up of uncontrollable economic, social, psychological, legal, and other phenomena. Decisions on marketing organization must necessarily precede decisions on other marketing controllables. Be-

fore product and price decisions can be made, for instance, we have to decide *who* should make them. We must decide in advance, too, the question of which decisions will be made *where*—which ones will be made by executives in the home office and which ones by their subordinates in the field. And because marketing decisions are typically related not only to each other but also to decisions in such areas as production, personnel, finance, and general management, we must also decide in advance the question of *who will coordinate* which marketing decisions. We must decide, for example, who will coordinate selling and advertising decisions with product decisions, and who will coordinate these decisions with production, personnel, finance, and general management. Marketing organization, then, is not an end in itself but a means to the end of marketing performance and marketing results.<sup>1</sup>

An organization is the framework of relationships among all persons in a group, specifying the responsibilities and authority role of each individual. It is an impersonal system of coordinated human effort designed to accomplish the goals of management. The elements of an organization are communication, willingness to serve, and purpose. Its people must be able to communicate with each other and be willing to work toward a common purpose. All complex organizations are built up from a number of smaller units. They consist of working (or basic) organizations overlaid with executive organizations.<sup>2</sup> An organization is set up to make and implement decisions, so the executive organization may be described as a network of decision-makers, while the working or basic organization is concerned primarily with carrying out decisions. In some instances, decisions are made even at the lowest levels of the organization, and this is particularly characteristic of marketing organizations, where even salesmen make decisions that influence the buying decisions of customers. In order to discuss organizational problems and decisions in marketing, we should first review some concepts and models from organization theory.

#### ORGANIZATION CONCEPTS AND MODELS

Organizations contain formal and informal structures. In a complex organization it is difficult to distinguish clearly between formal and informal structures, but such a division makes it easier to understand the important aspects of organization theory. The formal organization may be thought of as the "official" hierarchy established by the top executive, and the informal organization as the unofficial hierarchy established by social sanc-

<sup>1</sup> Paraphrased from: P. F. Drucker, *The Practice of Management* (New York: Harper and Brothers, 1954), p. 194.

<sup>2</sup> Chester I. Barnard, *The Functions of the Executive* (Cambridge, Mass.: Harvard University Press, 1938), p. 19.

tion. The early or "traditional" theories of organization were concerned only with the formal authoritarian structure, but recent contributors to organization theory have concentrated on the social factors affecting organizations.

### *Traditional Organization Theory*

Traditional organization theory is based on authority—the right to command. This viewpoint is expressed by Erwin Haskell Schell in these words: <sup>3</sup>

If we are to have control, we must provide avenues through which it can function easily and directly. These avenues we speak of as paths of authority. They pass from administrators who determine policy, to the executives who are responsible for the performance of policy, and then to the employees who perform the actual operations.

Traditional organization theory has frequently been described as "the machine" model because it treats workers as automatons. Workers are to be bought and sold. Personalities are not important, and workers are expected to adjust to the jobs, not to have the jobs adjusted to them. Traditional organization theory developed early in the twentieth century. The first attempt to define formal organization theory was made at the turn of the century by Weber. The authoritarian approach fitted well into the philosophies of Frederick W. Taylor, originator, and the Gilbreths, supporters, of the scientific-management movement in the early part of the century, so that authoritarian organization became a part of this movement. By the mid-1930's traditional organization theory had probably reached its peak of refinement as expressed in the Mooney and Reiley Model.

**THE WEBER MODEL.** Late in the nineteenth century, Max Weber, a German sociologist, made a systematic analysis of bureaucracy, or government organizations, and proposed an ideal type of organization. The features of his ideal bureaucracy, which are equally applicable to large-scale business organizations, emphasize form of organization and professional management. The features of his model are as follows: <sup>4</sup>

1. *The concept of hierarchy.* Each job or task is under the control of a higher office, and people are secondary to the requirements of the hierarchy.

<sup>3</sup> Erwin Haskell Schell, *The Techniques of Executive Control* (New York: McGraw-Hill, 1957), p. 58.

<sup>4</sup> For a more detailed description of the Weber model see: James G. March and Herbert A. Simon, *Organizations* (New York: John Wiley & Sons, 1958), Ch. 2, 3; Albert H. Rubenstein and Chadwick J. Haberstroh, *Some Theories of Organization* (Homewood, Ill., The Dorsey Press, 1960), Ch. 4; and John M. Pfiffner and Frank P. Sherwood, *Administrative Organization* (Englewood Cliffs, N.J.: Prentice-Hall, 1960), Ch. 4.

2. *Accepted norms of conduct.* Policies should be carefully stated so that there is as little as possible in the organization that is unpredictable.
3. *Job specification.* Each member of the organization is selected on the basis of his ability to perform a special portion of the total task.
4. *Clearly stated spheres of competence.* The duties of and relationships between the various specializations are clearly defined—e.g., job descriptions.

Weber's model has provided the conceptual core for most of the research in organization by social scientists, although few industrial writers on organization were even aware of his model until very recently. His essential proposition was that the bureaucratic model is more efficient than alternative forms of organization. Without denying this essential proposition, the research of three social scientists—Merton, Selznick, and Gouldner—has suggested that there are important unplanned results of the bureaucracy model.<sup>5</sup> The Merton model, for example, is designed to demonstrate that efforts on the part of the top hierarchy to increase the reliability of behavior of subordinates eventually produces rigidity of behavior, which, in turn, increases the amount of difficulty with clients of the organization and complicates the achievement of client satisfaction.

**THE MOONEY AND REILEY MODEL.** James D. Mooney and Alan C. Reiley, both General Motors executives in the early 1930's, attracted considerable interest at that time with the publication of their book, *Onward Industry*. In this book they proposed four main categories of organization "principles": the scalar principle, the functional principle, the coordinative principle, and staff-and-line.<sup>6</sup> The first two principles are essentially the same as Weber's "hierarchy" and "job specialization." The scalar principle (hierarchical) refers to the vertical division of authority and definite assignment of duties to units in the organization. The functional principle is really the Weber concept of specialization, embodying the use of trained specialists in each horizontal job category. The coordinative principle provides for unity of action toward a common purpose; it depends on authority and leadership, but also on doctrine, spirit, and morale. Staff-and-line is proposed as a unifying concept with line representing authority, and staff representing advice and ideas.

**SUMMARY OF TRADITIONAL THEORY.** Traditional organization theory is built on two basic assumptions: dehumanization of the organization, and

<sup>5</sup> For detailed descriptions of the Merton, Selznick, and Gouldner models, see: James G. March and Herbert A. Simon, *op. cit.*, pp. 36-47.

<sup>6</sup> The Mooney and Reiley Model, as subsequently refined, is presented in detail in a second book by the same authors: James D. Mooney and Alan C. Reiley, *The Principles of Organization* (New York: Harper and Brothers, 1939).

an autocratic or undemocratic bias. Most of the newer organization theory has evolved from strong disagreement with these assumptions. Dehumanization implies that the job is all important. Jobs are not adjusted to workers; workers are expected to adjust to their jobs. It resulted in the strongly authoritarian concept of the job-task hierarchy, with all relationships in the hierarchy determined by an individual's job. It supported the scientific-management movement of the early twentieth century with its objective of dividing work into its component parts, arranging tasks into effective production sequences, and dividing jobs into tasks so small that a worker would spend the entire day repeating a small routine operation. Dehumanized organization provides for financial incentives based on some measure of production as the only important means of motivating employees. Productivity is the one standard of value for evaluating individuals within the organization.

The authoritarian bias of traditional organization theory is based on the assumption that all wisdom and knowledge rests at the top of the hierarchy. With the exception of reporting results, all communication is downward. Policy and orders come from the top, and they are not to be questioned. It is the prerogative of the top manager under this undemocratic concept to dispose of people as he would goods and property. The right to hire and fire is his alone, to be delegated as he sees fit.

Because of disagreement with these basic assumptions underlying the machine model approach to organization, a number of new approaches to organization theory have evolved since the 1930's. In addition, continuing research has resulted in a broadened understanding of man and social institutions which has made many of the concepts of traditional theory inadequate or untrue.

#### *Modern Organization Theory*

Even in the most highly structured, authoritarian organizations, there exists beside the formal structure an informal organization or way of getting certain things done. This is because people will not all fit the mold of a formal organization. This informal organization allows many things to get done outside of the normal chains of command and communication. "Let me talk to my friend Bill. Maybe he can straighten it out." "Don't worry about Jim. He never concerns himself in these matters. Take it directly to the boss." Such situations exist because organizations are made up of individuals who cannot and will not conform to the machine model. Whereas traditional organization theory was rooted in authoritarian concepts, the more modern organization theory reflects the democratization of industry that has taken place in the past half century. Organization of the marketing function, in particular, should recognize this democratization. The nature of many marketing responsibilities calls for



initiative and independent action by individuals low in the organizational hierarchy (such as salesmen) and democratic organizations help achieve this initiative.

You should avoid, however, accepting too readily the easy conclusion that all conformity in an organization is necessarily bad. Mr. Frederick R. Kappel, President of American Telephone and Telegraph Company, states this warning very clearly: <sup>7</sup>

Successful organized effort depends on the power of individuals to make highly personal contributions. To make his best contribution, a man must be his own unique self and he must always know who he is. But whenever two people come together to do something, there must be some conformity. To some extent they must think and act alike. Otherwise any organized society would be impossible. There is a lot of conformity in every group effort—government, business, education, religion. To be against all conformity is to be against order and for chaos.

Modern organization theory is concerned with the individual member of the organization. It has two basic approaches—human relations and decision-making. The human relations approach looks at the feelings and motives of the individual. Its impact was first felt in the 1920's, and it is well-described in the writings of Elton Mayo.<sup>8</sup> The decision-making approach examines the adaptive and reasoning abilities of people and is described by James G. March and Herbert A. Simon.<sup>9</sup> P. J. Gordon has suggested a third approach, the operational view, as a particularly appropriate way for the marketer to look at organization theory.

**THE HUMAN RELATIONS APPROACH.** The human relations approach to organization has evolved from a new concept of human motivation. Employee motivation, like consumer motivation (as described in Chapters 7 to 9), was first thought of as rational and economic, but recent research has shown that economic motivation only operates until the individual achieves a subsistence-level income, and that after that, factors such as personal recognition and self-fulfillment are all important. Douglas McGregor is a strong supporter of the view that people are not by nature passive or resistant to the needs of the organization. He says: <sup>10</sup>

People, deprived of opportunities to satisfy at work the needs which are now important to them, behave exactly as we might predict—with indo-

<sup>7</sup> F. R. Kappel, *Vitality in a Business Enterprise* (McGraw-Hill, 1960), p. 75.

<sup>8</sup> See: Elton Mayo, *The Social Problems of an Industrial Civilization* (Boston: Harvard Business School, 1945).

<sup>9</sup> March and Simon's decision-making approach is described in detail in: James G. March and Herbert A. Simon, *Organizations* (New York: John Wiley & Sons, 1958).

<sup>10</sup> Douglas M. McGregor, "The Human Side of Enterprise," *Some Theories of Organization*, edited by Albert H. Rubenstein and Chadwick J. Haberstroh (Homewood, Ill.: Richard D. Irwin, 1960), p. 184.

lence, passivity, resistance to change, lack of responsibility, willingness to follow the demagogue, unreasonable demands for economic benefits.

McGregor and other supporters of the human relations approach believe that motivation and the capacity for assuming responsibility and doing more than the minimum job are present in all people, and that it is the responsibility of management to help people develop these characteristics.

The traditional concept of authority extending from the top downward in the organization has required modification because of the newly recognized "upward" authority. Through their freedom to obey or disobey orders from their superiors, all subordinates demonstrate this authority. An employee grants authority to his superior through his willingness to obey orders. When he chooses to disobey orders, he denies the authority of the superior giving the orders. The employer may have the right to discharge an employee for such disobedience, but the need for good public and employee relations, or the existence of a strong union, may make such action unwise.<sup>11</sup>

The corollary to this broad approach to human motivation and responsibility is a new and less authoritarian approach to organization. The new approach includes decentralization and delegation of authority, enlargement of job responsibility at all levels, participation at all levels in management decision, and participation by the individual in appraisal of his performance. This concept of group leadership is not acceptable to all groups, however. William H. Whyte, Jr., expresses the feelings of the dissenters in *The Organization Man*,<sup>12</sup> when he deplores the possible adverse effects upon business's future supply of strong leaders—the individualists who are often responsible for important innovations.

**THE DECISION APPROACH.** The March and Simon model is based on the belief that the role of the individual is too large a unit of analysis on which to build a theory of organization. An individual may make a number of decisions on varying subjects during a day. For this reason, the individual decision premise is used as the appropriate unit. March and Simon fit this decision unit into the broad area of organization theory as an addition to, and not a substitute for, the earlier traditional and human relations approaches. The central notion is that a decision is a conclusion drawn (although not necessarily in a strictly logical sense) from premises (previous propositions), and that authority is used when the decision-maker communicates the decision to the individual(s) selected to execute it; this decision, in turn, becomes a premise for subsequent decisions. It is

<sup>11</sup> Perrin Stryker, "How Executives Delegate," in *The Executive Life* by the Editors of *Fortune* (Garden City, N.Y.: Doubleday, 1956), p. 141.

<sup>12</sup> William H. Whyte, Jr., *The Organization Man* (New York, Simon and Schuster, 1956).

evident that the availability of information and the facilities for processing and analyzing information are the really critical factors in the decision process. Some experts consider decision-making and communication so interrelated as to be inseparable in practice. According to Dorsey, a decision occurs on "the receipt of some kind of communication, it consists of a complicated process of combining communications from various sources and it results in the transmission of further communication."<sup>13</sup>

In the opinion of a number of experts, information is the life blood of the functioning organization, so the channels for transmitting such information are necessarily part of the organization structure. These channels, or communication networks, are described by March and Simon:<sup>14</sup>

Associated with each program is a set of information flows that communicate the stimuli and data required to evoke and execute the program. Generally this communication traverses definite channels, either by formal plan or by the gradual development of informal programs. Information and stimuli move from sources to points of action; instructions move from points of decision to points of action; information of results moves from points of action to points of decision and control.

Some communication channels are planned, but some develop through usage. The planned networks are those that follow the hierarchical channel of authority; unplanned networks develop among individuals with common backgrounds who find communication easy or necessary. New technologies, such as integrated data processing, cut across superior-subordinate work relationships, affecting the jobs of people in different departments and work groups. Superimposing a vertical organization on such horizontal relationships as this results in unplanned communication networks. Thus, a marketing researcher, in attempting to plan a method of processing information from a consumer survey, may directly seek the help of the computer programmer, who works in a different department, instead of going through his and the other man's "bosses." In such instances, the feedback of information is most likely to come through unorthodox channels.

**THE OPERATIONAL APPROACH.** This approach interrelates three factors: the firm and its marketing components, the environment, and growth trends. Here growth is thought of as being either increasing, static, or decreasing. The organization "functions as a catalyst, facilitating growth and change."<sup>15</sup> The approach starts with the consumer and seeks the best

<sup>13</sup> John T. Dorsey, Jr., "A Communication Model for Administration," *Administrative Science Quarterly*, December 1957, p. 309.

<sup>14</sup> James G. March and Herbert A. Simon, *op. cit.*, pp. 166-167.

<sup>15</sup> P. J. Gordon, "Theories of Organization," *Business Horizons*, Special Issue—First International Seminar on Marketing Management (February 1961), pp. 22-23.

combination of customers, distributors, territories, and channels of distribution for the particular product. Mr. Gordon defines this approach as growth centered, seeking the best balance between organizational change and changing conditions. The best organization for marketing cannot be rigidly defined because changing conditions will soon make any one plan obsolete.

### DECISIONS ON MARKETING ORGANIZATION

Earlier we pointed out that the organizational structure provides the framework within which decisions are made. Marketing organization decisions range from the determination of the place of marketing in the overall structure of a business to assignment and delegation of authority.

#### *The Place of Marketing in the Organization*

The most important decision on marketing organization is that of determining the relationship of marketing to the other functions and responsibilities in a business. The role of marketing in the organization structure of American business has become increasingly important as markets and businesses have become more complex. Gradually, as increasing productivity in many industries has made it possible to produce far in excess of existing demand, it has become clear that more attention must be given to marketing. It is out of this need that business has evolved the so-called "marketing concept."

**THE MARKETING CONCEPT.** A newly evolved business concept (called "the marketing concept") has an important potential effect on marketing organizational decisions in many firms, and for this reason, you should be familiar with it. The marketing concept is a philosophy applied to the operation of a business in which customer and consumer needs will be uppermost in importance. These needs will govern the separate planning of each function of the business, as well as the overall plan aimed at achieving its predetermined profit objectives.<sup>16</sup>

Under this concept, marketing is the catalyst that brings together the technological complex of business and the consumer and industrial markets, which have been built on the desires of individuals to find better ways to satisfy their wants. This philosophy of marketing is based on two fundamentals. First, marketing has a dual job. It must direct the attention of business to the customer's needs and desires, and it must persuade the prospective customer through all the available techniques of selling and advertising. This last phase of the job—that of persuading the customers—has long been recognized as the primary responsibility of mar-

<sup>16</sup> A. Felton, "The Marketing Concept in Action," *Business Horizons*, Special First International Seminar on Marketing Management (February 1961), pp. 14-16.

keting, and many businessmen have only recently begun to realize that the assessment of customers' needs is a necessary preliminary step. Of course some retailers and sales executives have long believed that the customer is king. Marketing people must point out to business the consumer needs, both conscious and unconscious, that will affect the products or services to be offered. With recognition of the first phase, the emphasis in the persuasion phase has shifted from selling the product to selling the *function* that the product will perform. The second fundamental underlying this philosophy of marketing is emphasis on the profit concept rather than the volume concept. Additional sales volume at any price is no longer the aim. Instead, the aim is maximization of profits.<sup>17</sup>

**THE TOTAL ROLE OF MARKETING.** How far each firm moves toward adoption of the marketing concept is a decision for top management. This decision is influenced by several factors. Perhaps the most important is the current status of markets. Increases in average consumer income with resulting increases in discretionary buying power have offered enormous increases in the market potential for many products, but at the same time have made it necessary for some businessmen to compete not only with products similar to their own but also with entirely different products. For example, a housewife with \$400 extra to spend on something she really wants may be torn between buying a freezer or a fur coat. In competing for her discretionary dollars, freezers compete directly with fur coats. Another factor has been the increasing cost of establishing and maintaining distribution structures, which tends to freeze existing patterns and practices at the expense of change. As it becomes more expensive to rectify mistakes, more attention is given to planning marketing activities correctly in the beginning. A third factor has been the increased difficulty in achieving internal communication. With increased specialization of functional responsibilities accompanied by diversification of product lines, the need for coordination and establishment of clear lines of authority and responsibility has increased.

A company that adopts the marketing concept should organize its activities accordingly, but this need may go unrecognized. According to one writer: "Companies may have the will and the desire to serve the customer, but all too often they are inadequately organized to do so. Proper organization must result in a total integration and coordination of all of the factors that can influence the final sale. This is the very essence of the modern marketing concept. . . ." <sup>18</sup>

<sup>17</sup> F. J. Borch, *The Marketing Philosophy as a Way of Business Life*, General Electric Marketing Information Bulletin, 1957, p. 4.

<sup>18</sup> A. E. Cascino, "Organizational Implications of the Marketing Concept," in W. Lazer and E. J. Kelley (Eds.), *Managerial Marketing: Perspectives and Viewpoints*, rev. ed. (Homewood, Ill.: Richard D. Irwin, 1962), p. 371.

**CENTRALIZATION OF MARKETING ACTIVITIES.** As businessmen have come to recognize marketing as a single broad business activity, that involves coordination and optimization of a number of subactivities, they have had to re-examine the place of these individual activities in the organizational structure. Sales force management, advertising, and marketing research, for example, have been traditionally organized as separate departments reporting directly to top management. Centralization of these activities under a single marketing executive, by improving coordination, should increase marketing efficiency. There has been a strong trend towards such centralization of marketing responsibilities in American businesses, but each top executive must decide for himself whether the improved coordination will outweigh the potential human relations and communication problems. If the chief executive decides to centralize marketing authority, it is then his responsibility to sell the lower echelons of management on such action. It is often a difficult task to persuade sales managers, advertising managers, marketing research managers, traffic managers, and production managers to cooperate with or, in some instances, to take direct orders from this new marketing executive. The success of such a marketing executive depends to a large extent on two factors, his knowledge of the consumer, and his logistical skill—his ability to balance the various business resources placed behind the product. By achieving the optimum balance between potential product improvements, production costs, sales and advertising costs, alternative channels of distribution, and costs of physical distribution, he will attain maximum profit for his firm.<sup>19</sup>

**RELATIONSHIP TO OTHER BUSINESS ACTIVITIES.** Advertising, sales force management, and marketing research are generally recognized as marketing activities, and responsibility for them is normally assigned to one or more marketing executives. The formulation of policy on channels of distribution is also generally recognized as a responsibility of marketing executives. However, there are other areas of policy formulation for which marketing should assume at least a share if not all of the responsibility. One of these is pricing, which in some companies is the responsibility of the production manager or the controller. Another is merchandising or product policy. Although marketing executives occasionally have been allowed to share this responsibility, production or research and development have had the sole responsibility in many firms. Another policy responsibility closely related to marketing is the management of physical distribution, involving control over finished goods inventories, transportation, and storage. The effectiveness of marketing operations often depends largely on the proper management of this responsibility, so marketing should have a share in the determination of policy. The final decision as

<sup>19</sup> Eugene B. Mapel. *op. cit.*, pp. 4-5.

to the allocation of responsibility for these interfunctional activities must be made by top management. And it is in decisions of this kind, involving complex interrelationships, where human and communication factors are likely to be more important than traditional authority and job-task relationships.

A final responsibility that is often the concern of more than one executive is that of control over marketing activities. This responsibility, traditionally assumed by the accounting department or the controller, is important to the marketing manager because of its effect on his ultimate goal, that of maximizing profits.

#### *Organization Within the Marketing Department*

Necessarily, the executives in a very small marketing department must be able to deal with all types of marketing problems. But in a large organization, the number of executives and multiplicity of responsibilities makes it both desirable and necessary to divide these responsibilities. A great many of the marketing executives in large organizations must be specialists, with technical knowledge of particular activities such as advertising and research. The chief marketing executive has the responsibility to delegate and divide line and staff authority.

The increasing centralization of marketing responsibilities and the growing complexity of the marketing task has led to recognition that a new kind of chief marketing executive is required. Although he must still have a high degree of administrative skill, the top executive is no longer responsible for the line sales force management activity. This responsibility is delegated to a subordinate general sales manager. The typical top marketing executive of this new type has been described as follows: <sup>20</sup>

He tends to be more thoughtful, sometimes skilled more in handling ideas than in handling men. He is more objective, analytical, less emotionally involved in his assignment. He has begun demanding research—searching for ideas, thinking of both strategy and tactics.

With the reduced top level concern with sales force management, marketing staff departments have grown in influence and in numbers. Established staff responsibilities, such as advertising, marketing research, and credit management have a greater total impact when they are brought together under one head. New staff responsibilities, such as product management, have achieved important roles in the marketing structure.

**THE DIVISION OF MARKETING LINE AUTHORITY.** One description of line activities includes all activities associated with order-giving in the line of

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<sup>20</sup> D. R. Longman, "The Role of the Marketing Staff," *Journal of Marketing*, Vol. 26, No. 3 (July 1962), pp. 31-32.

command and with direct labor. In a very small organization, where all members report to a single superior who coordinates their activities, everyone is in the direct order-giving chain of command and engaged in direct labor, and this is strictly a line organization.<sup>21</sup> But since the size of most marketing organizations requires that there be more than one executive, some individuals must be designated as line executives. Salesmen are the direct labor producers in marketing, so the sales manager is the marketing line executive.

Overall responsibility for management of the sales force will reside with a home-office line executive, and, as pointed out above, in modern organizations he is subordinate to the top marketing executive. But a single line executive can only handle a very small, geographically concentrated sales force, because of the time required to visit and supervise each individual salesman. As a sales organization becomes too large to be administered by one man, it becomes necessary to select a satisfactory basis for dividing the sales force into sub-groups. Each sub-group must then be placed under the direction of a line assistant to the sales manager. The decision as to whether to divide the sales force along geographic, product, or market lines will vary according to the needs of the organization.

1. *Organization Along Geographic Lines.* When the sales force covers a broad geographic area, it is often practical to divide it along geographic lines. By locating divisional sales managers and their offices in various parts of the country, each sales manager is placed in closer contact with the salesmen under his direction.<sup>22</sup> With this reduction in physical distance, personal contacts with and supervision over the salesmen are simplified. Large national organizations covering the market intensively may find it necessary to provide further subdivision by dividing the authority under each division sales manager among regional managers.

Division of authority along geographic lines is particularly useful when characteristics of the market or consumers vary considerably between different regions. In such instances, each sales division or region can adapt its selling methods to the needs and customs of the local market.

2. *Organization Along Product Lines.* A firm's line of products will often dictate organizational structure. If the products are basically similar, there will be no need to provide specialized salesmen for each product. But when the variation among products requires considerably different methods of selling and different technical knowledge on the part of sales-

<sup>21</sup> E. H. Anderson and G. T. Schweuning, *The Science of Production Organization* (New York: John Wiley & Sons, 1938), p. 125.

<sup>22</sup> Recent increases in the speed of public transportation have reduced the necessity for locating a sales executive close to his subordinates. The Underwood-Olivetti Company, for example, although it has organized its sales department along geographic lines, houses all of its regional sales executives in its home office in New York in order to maximize communication and coordination at the management level. Each regional sales executive commutes from the home office to his region.



men, it becomes reasonable to divide the sales force along product lines. General Electric needs very different kinds of salesmen to sell large electric generators and television sets. The generator salesman must have considerable technical training, whereas the television salesman needs far less technical training. It would be wasteful to use the more technically-trained man to sell both products, so two separate sales forces are used, each qualified to sell its line of products, and each product assigned to a different sales executive.

Maintaining separate sales forces for different product lines is expensive, because it often results in the use of more than one salesman to cover the same area. For this reason, the benefits should clearly outweigh the extra cost. These benefits are greatest for companies selling broadly diversified lines of products, for those reaching different markets with different products, and for those with unique selling problems for the different products.

3. *Organization Along Customer or Channel of Distribution Lines.* When the customers or markets for a product or product line vary considerably, it may be desirable to organize separate sales forces to serve each. A power-saw manufacturer may sell the very same product to two very different industries—e.g., the lumber industry and the construction industry. These two industries have different geographical concentrations (the lumber industry is concentrated primarily in sparsely populated parts of the northwest and southeast; whereas the construction industry is broadly distributed in relation to population and industrial concentration) and different buying practices, and under these circumstances, separate sales forces may be able to do the job more effectively.

Many producers of consumer goods sell the same products through several different channels of distribution. Part of the sales volume may reach the consumer through distributor and independent retailer channels, while another part may be sold directly to chain store buying offices. Still another part may be sold to foreign markets through export agents. The type of selling required in each case may be quite different, and the number and kinds of buyers will vary. (It would, for example, require only a very few salesmen to reach all chain store buying offices in the national market, but it would require dozens or hundreds to reach all wholesalers.) Producers with such varied channels of distribution frequently find it advantageous to organize separate sales forces to cover each channel.

4. *Dividing Line Authority on Several Bases.* A great many companies use more than one basis for dividing line authority in the sales department. Large sales organizations require several levels of management, and different methods of division may be used at different levels. When product differences require a division of responsibility along product lines, the entire sales force may be divided on this basis, but if the resulting product division requires further subdivision, this may be done on a

geographic basis. Thus, the resulting organization provides sales specialization both in terms of different product lines and geographical differences in the market.

**THE DIVISION OF MARKETING STAFF AUTHORITY.** Staff people theoretically have purely advisory roles with no place in the command structure and without the right to give orders, but this clear distinction does not exist in practice. The nature of his work gives the staff executive an intimate and broad view of line executives' problems that almost inevitably gives him *informal* authority. Added to this is the fact that staff work is intellectual in character. As one authority expresses it: "Line administrators tend to be conservative, pragmatic, and inclined to make decisions on the basis of their experience and accumulated value systems. The staff person has his time free to gather data, study, reflect, and come up with solutions arrived at through intellectual processes. He is the thinking and planning arm of the organization. He must inevitably wield power."<sup>23</sup> In addition, with management relying more and more heavily on processed information, the staff authority to advise becomes an authority to *screen*—and thus to make decisions.

An important organizational decision for marketing management is the division and allocation of staff authority. We have described staff work as an intellectual process, a process of thought aimed at attaining maximum coordination between the various segments of the organization. Pfiffner and Sherwood suggest that three basic elements are involved in staff work: fact-finding, planning and organizing.<sup>24</sup> They use the term organizing in a sense closely akin to coordinating.

The informal authority of staff administrators often extends downward in the management hierarchy. As top management recognizes a staff executive as an authority rather than just an advisor in his area of competence, lower levels of management become aware of recognition by top-management. They tend to accept staff recommendations as being backed by top-management. The development of such a dual line of command creates a more complicated organization structure than that portrayed by the line and staff structure.<sup>25</sup>

Exhibit 15.1 shows a fairly typical organization structure for a firm organized to treat marketing as a single unifying responsibility. It divides the responsibility of marketing management into two broad categories: the management of personal selling (the purely line responsibility), and marketing services (the staff responsibilities). The subdivisions on the

<sup>23</sup> John M. Pfiffner and Frank P. Sherwood, *Administrative Organization* (Englewood Cliffs, N.J.: Prentice-Hall, 1960), p. 173.

<sup>24</sup> John M. Pfiffner and Frank P. Sherwood, *op. cit.*, p. 176.

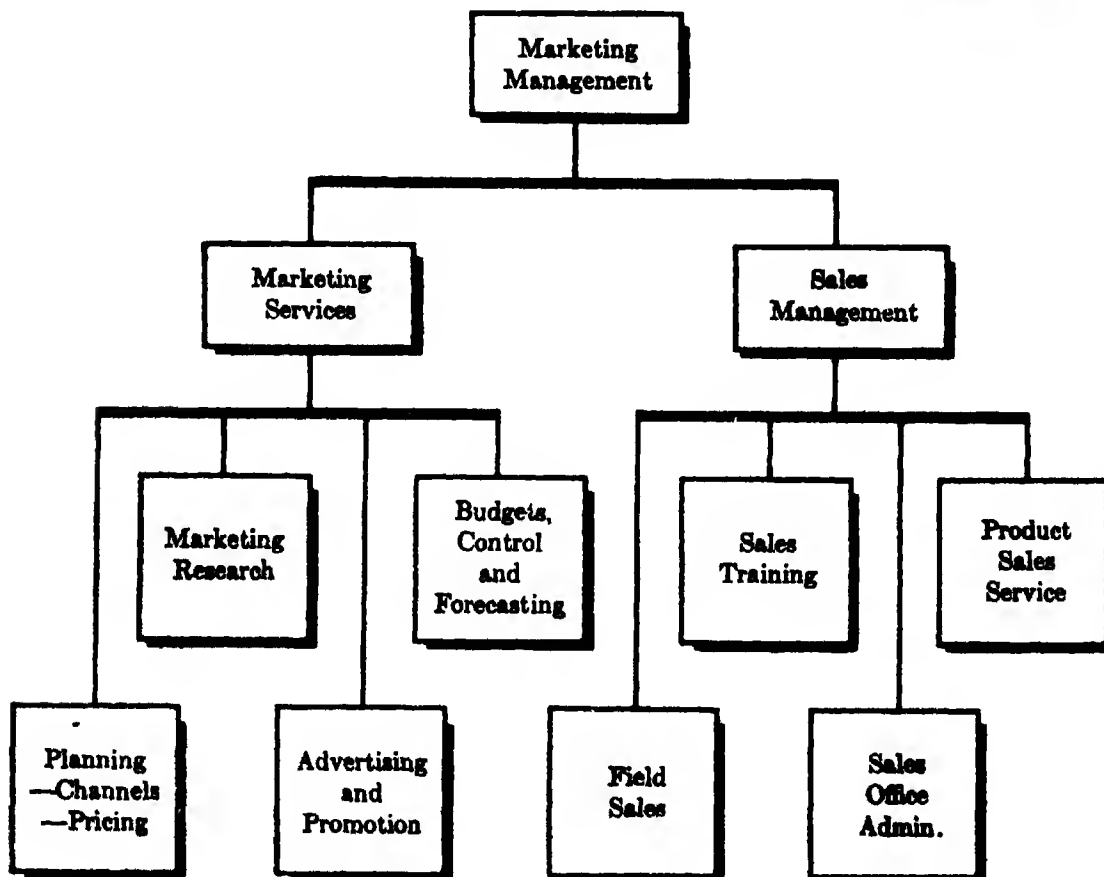
<sup>25</sup> R. Carzo, Jr., "Organizational Realities," *Business Horizons*, Vol. 4, No. 1 (Spring 1961), p. 99.

marketing-services side fit fairly well under the three categories of basic elements described above; marketing research is the fact-finding function; planning, of course, is planning; and budgets, control and forecasting, as well as advertising and promotion, can be classified as organizing.

Staff, or functional, responsibilities are generally concentrated in the central marketing office, because many of these activities are similar for all products, channels of distribution, and geographic regions. Such centralization allows coordination of efforts and a pooling of financial resources so that the best available personnel and equipment can be utilized. Without good staff liaison at headquarters, some divisions would make decisions for their own good, rather than for the good of the entire company, e.g., long-range research projects might be omitted because of their immediate effect on division profits. A strong central staff will keep division executives aware of broad company policies.

If the marketing structure is very large, it may still be necessary to provide assistance in the performance of functions (services) in subsidiary offices. In such instances, it must be decided whether (organizationally) to place these subsidiary staff executives under the authority of the central

Exhibit 15.1



office staff executive, or under the local line executive. As in other organization decisions, the solution rests in compromise between the authority, communication, coordination, and human-relations needs of the group.

To be effective, organization decisions must recognize the existence of informal as well as formal structures. Informal structures develop either because of a failure to provide for all communication and decision-making needs within the formal structure, or because other channels of communication are easier or more natural for the participants. For example, there are two types of functional marketing responsibilities: those that are solely the concern of marketing, and those that are the joint concern of marketing and one or more other operating divisions, e.g., product planning, production planning and scheduling, and physical distribution. The first type of responsibility can be clearly and easily defined in the organizational structure. The second type of responsibility involves cooperative action between divisions and may not even be shown on the organization chart of the marketing department. In some instances, it is not formally recognized anywhere in the structure of the organization, and simply operates on an informal basis.

**THE ROLE OF THE PRODUCT MANAGER.** The product manager is becoming more important in marketing organizations today. Many large multi-product firms have found that the division of marketing responsibilities along lines similar to these in Exhibit 15.1 have not provided proper attention to individual products. As already pointed out, many companies divide their selling responsibility along geographic or market lines. Even where the field sales force is divided along product lines, central office staff responsibilities (e.g., advertising and promotion) are under a common authority. The result, then, is that individuals are not interested in, or responsible for, the success or failure of individual products. Thus, there is the danger that some products will receive too little or too much promotion, that advertising programs for particular products will not be coordinated with sales activities, that changes in consumer needs and competitors' actions with respect to individual products may go unnoticed. The product manager fills this vacuum. He is, in effect, a deputy marketing director for a particular product or product line. Although his responsibilities and authority vary considerably in different companies, he is normally responsible for the planning, execution, and control of marketing activities for his product line.

#### *Delegation of Decision-Making Authority*

With the increasing demands on the time of the modern marketing manager, it has become desirable to delegate as much authority as possible to subordinates. Yet, this is a line of action management is particularly re-

luctant to follow. As Koch expresses it, "There are too many managers who simply will not trust their subordinates, and who want to keep the fun of the game to themselves."<sup>26</sup> Increasingly, however, lower-ranking marketing executives are being granted more decision-making power. In a recent overhauling of its marketing organization, Mobil Oil Company, for instance, granted its regional marketing managers the authority to make decisions on service station sites without higher approval.<sup>27</sup> Nevertheless, because so many marketing problem situations are non-routine in nature, the natural tendency of a great many chief marketing executives is to retain the bulk of decision-making power in their own offices.

### *Span of Control*

The number of men who can be effectively controlled by a supervisor or administrator varies widely in different circumstances. The degree of centralization or decentralization of decision-making authority in a marketing organization, usually described as the span of control, is determined by the top marketing executive. His decision may be affected by several factors: his evaluation of traditional views, his desire for self-reliance among subordinates, and effectiveness of communication.

**THE TRADITIONAL VIEWPOINT.** A basic part of the traditional approach to organization theory is the concept of a narrow span of control. According to this concept, there is some optimum number of men that can be effectively controlled by a supervisor, that most efficient number being below the maximum. And, in general, any reduction in span of control is considered an improvement.

One of the most effective critics of the traditional view is Herbert Simon,<sup>28</sup> who pointed out that no one was able to agree on an ideal number, since the personality of the executive, the geographic dispersion of those being supervised, and the nature of the work all affected this number. There has been very little research conducted to support either the traditional view or Simon's view. Critics of the narrow-span-of-control concept base their views on observed inconsistencies and personal observation of effective administrative situations with very broad spans of control. The main criticism of the narrow span of control is the resulting proliferation of administrators. For example, in an organization of 300 salesmen, a reduction of the span of control from 30 to 15 would increase the number of supervisors from 10 to 20, and, since 20 supervisors would

<sup>26</sup> Edward G. Koch, "Three Approaches to Organization," *Harvard Business Review*, March-April 1961, p. 162.

<sup>27</sup> *Business Week*, August 15, 1959, p. 70.

<sup>28</sup> Herbert A. Simon, "The Proverbs of Administration," *Public Administration Review*, Winter 1946, pp. 53-67.

be considered too many for a single sales manager to control, it would be necessary to add a layer of two to four district sales managers between the sales manager and the sales supervisors. But despite such criticisms, the traditional concept still has strong supporters.<sup>29</sup> Willingness to accept the concept of a broad span of control is related to an administrator's confidence that operations can run smoothly without his constant personal supervision. Lack of such confidence implies ineffective control by the executive. This point is well illustrated by W. T. Jerome, III:<sup>30</sup>

Where there is an effective system of executive control, the span of control can be, and should be, greatly extended. The span can be extended because the process of planning, programming, and appraisal if properly conducted serves as a self-policing, self-motivating, sort of control. In other words, the direction of operations is done more by goals, rather than by an ever-present superior.

**RELATION TO DELEGATION OF AUTHORITY.** The span of control can be broadened markedly if the administrator is willing to delegate considerable authority to his subordinates. In fact, for those who consider broader delegation a desirable move, a wider span of control is an effective way to insure its achievement. The Sears, Roebuck and Company organization has been cited as a working example of such a policy:<sup>31</sup>

In an organization with as few supervisory levels as Sears, it is obvious that most key executives have so many subordinates reporting to them that they simply cannot exercise too close supervision over their activities. By this means, substantial decentralization of administrative processes is practically guaranteed.

The operating policy of J. C. Penney Company, before its incorporation in 1913, offers a more striking example of a broad span of control and resulting delegation of authority. Each of the 34 stores in the chain was operated as a partnership between Mr. Penney and a store manager. Mr. Penney established common operating policies and provided the coordination, but each store manager had a large amount of local autonomy.<sup>32</sup> This system worked so well that it was retained as an important feature of Penney organization even after the company grew into one of the country's largest business enterprises.

<sup>29</sup> For a carefully documented defense of the narrow span of control, see: Lyndall F. Urwick, "The Span of Control—Some Facts about the Fables," *Advanced Management*, November 1956, pp. 5-18.

<sup>30</sup> W. T. Jerome, III, *Executive Control—The Catalyst* (New York: John Wiley & Sons, 1961), pp. 129-130.

<sup>31</sup> James C. Worthy, "Factors Influencing Employee Morale," *Harvard Business Review*, January 1950, pp. 61-73.

<sup>32</sup> Norman Beasley, *Main Street Merchant* (New York: Bantam Books, 1950), pp. 60-75.

**COMMUNICATION AND SPAN OF CONTROL.** The need for constant communication between the superior and subordinates is often mentioned as a reason for needing a narrow span of control. It should be expected, then, that improvements in communication will permit a broader span of control. Electronic data processing can often provide the executive with more complete and accurate information than can his subordinates through personal communication. In effect, this should widen the executive's reach.<sup>33</sup> The need for middle levels of executives to receive, interpret, and transmit information is likely to be greatly reduced as electronic systems of processing information come into more widespread use.

### *Integrated Decisions*

Under committee management, decisions are made by a group of executives instead of by a single member of the organization. The proponents of this system believe that if it is approached creatively, and not just as a means of compromise, better decisions will result. One of the most successful examples of committee management is the executive committee at du Pont, which operates as a policy-making and review group above the 10 manufacturing and 14 staff departments.<sup>34</sup> The committee was set up to take care of the needs arising out of a broad program of product diversification. According to the members of the executive committee, some of the advantages of this system are these: less likely to go to extremes; better chance of coming up with a sound answer; benefit of diversified decisions; greater objectivity in decision-making.

Committee management is a controversial subject, and strong arguments have been proposed against it as well as for it. One writer considers it acceptable only on a temporary basis to "shore up deteriorating middle-management quality." In his opinion, in the long run committee management makes it difficult for junior executives to make decisions on their own and for top management to review their decision-making ability; it removes the risk of poor decisions from the executives' shoulders; it may lose its effectiveness because of domination by one or two strong executives; and it slows down the decision-making process.<sup>35</sup>

The strong need for coordination in the management of marketing makes committee management seem promising for certain types of broad

<sup>33</sup> Stahrl Edmunds, "The Reach of an Executive," *Harvard Business Review*, January-February 1959, pp. 87-96.

<sup>34</sup> William H. Mylander, "Management by Executive Committee," *Successful Patterns for Executive Action*, Excerpts edited from the *Harvard Business Review*, 1962, pp. 57-64.

<sup>35</sup> Arch Patton, "Old-Fashioned Initiative for Modern Enterprise," *Successful Patterns for Executive Action*, excerpts edited from the *Harvard Business Review*, 1962, pp. 105-106.

marketing decisions. Each marketing manager must decide for himself whether this organizational device can be useful to him. Dale has laid down three requirements for successful decision-making by committee: "homogeneity of outlook (toward the goals of their firm), egalitarian status, and heterogeneity of ability."<sup>36</sup> These requirements would normally be met in a group of top marketing executives. Some of the criticism leveled against committee management has been because of its misuse—that is, its use in decision areas where it is not appropriate. James Adams points out that creativity is one of these areas.<sup>37</sup>

I have never had any objection to group thinking and planning. The more information and the more viewpoints that can be brought to bear on a problem, the better for everyone who is to have a hand in the solution. But it is my honest opinion that a committee can't create an advertisement or intelligently criticize one. Creativity is an individual business.

### CONCLUSION

The concept of marketing organization should be a dynamic one. The development of the ideal marketing organizational structure is a job that is never finished. An organization that is satisfactory today may be inadequate tomorrow because of changes in the marketing task. The markets themselves change as the result of changes in income, shifts of population, changes in buying preferences, and so on. The channels of distribution change with the evolution of new types of middlemen and the decline of others. Products and product lines are continually being modified to adapt to the changing needs and desires of the consumer or user. A change in any one of these factors can reduce the effectiveness of an organizational structure, and since all of these factors are in a constant state of change, the need for regular reappraisal of the organizational structure is inevitable.

Changes in personnel may also require modification of the organizational structure. The purpose of an organization is to make optimum use of the talents of its personnel by identifying and defining responsibilities and making the best possible assignment for each staff member. An effective organization plan is tailored to the individuals involved. Thus, important staff changes often require a re-evaluation of the structure of organization and a realignment of responsibilities.

<sup>36</sup> Ernest Dale, *Planning and Developing the Organization Structure*, Research Report Number 20, New York, American Management Association, 1952, p. 28.

<sup>37</sup> James R. Adams, *Sparks Off My Anvil* (New York: Harper & Brothers, 1953), pp. 45-46..



**QUESTIONS AND PROBLEMS**

1. Can you support the statement that salesmen are more likely to have the authority and opportunity to make decisions than other employees of the company at a comparable organizational level?
2. Is the undemocratic bias of traditional organization theory a legitimate basis for criticism? Why shouldn't a business organization be operated autocratically in a capitalistic society?
3. Does the marketing concept require an increasingly important role for the marketing executive in the business organization? Would it change the relationships between marketing, production, and control?
4. How should marketing control responsibilities be divided between the chief marketing executive and the controller?
5. Which type of responsibility, staff (e.g., product manager or marketing research manager) or line (e.g., sales manager), is likely to give the best preparation for the new job of chief marketing executive?
6. What is your reaction to the statement that staff executives represent the thinking arm of the organization and line executives tend to react more automatically on the basis of experience?
7. Would it be proper to say that line marketing responsibilities and authority are described in the formal organization and that staff responsibilities are described in the formal organization, but staff authority is a part of the informal organization? Which kind of authority may be more important?
8. It has been said that the use of product managers results in conflicting demands on the time of salesmen and excessive intra-company product competition. Comment.
9. When the span of control of an executive is increased, his subordinates have more independence and authority. What is likely to be the resulting effect on coordination and cooperation?
10. Improved communication between the home office and field salesmen should eliminate the need for district sales managers and supervisors. Comment.
11. The almost continuous change in the organizational structure of many marketing organizations has been explained as resulting from the dynamic character of marketing. Is this only a rationalization?

12. Where do you think the responsibility for product planning and development should be placed in the organization in relationship to marketing responsibilities?
13. Does it really make sense to establish separate sales forces to sell the same product to two different markets since a salesman who knows his product should be able to sell it to anyone? Explain.
14. "A man with ten bosses has no boss. Similarly, when decisions are made by a committee, there is no single individual responsible, so the decisions tend to be made irresponsibly." Comment.

T H E

P R O D U C T

# 16

All product policies and decisions are directed toward a common goal—anticipation of the consumer's or user's needs and incorporation of these needs in the products offered for sale. Attainment of this goal requires that clear and concise product objectives be set to determine the direction of policies and decisions. Product objectives direct product planning down certain channels related to the company's distribution, type of selling, product scope, equipment utilization, and capital limitations. For example, if an objective of management is to increase utilization of the existing salesforce, its decisions on product-line additions will be restricted to products that can be

sold through their present channels of distribution. Product objectives set the ground rules under which management sets product policies and makes product decisions

The dynamic quality of today's markets has made re-evaluation of product policy and product decisions a continuous activity instead of a periodic, part-time responsibility. The increasingly important organizational status given to product planning and development is a reflection of this condition. Product policies and decisions fall under four main headings: composition of the product line; selection of standards of performance with respect to specifications, quality, and services; packaging; and branding.

### THE PRODUCT LINE

#### *Product Line Changes in Today's Market*

Throughout American business today, there is continuous development of new products, improvement of existing products, and an accelerating rate of product change. A recent Dun & Bradstreet survey of 760 manufacturers revealed that nearly a third of them considered new products their greatest single profit opportunity for the foreseeable future. And marketing experts generally seem to agree that the pace of new product introduction is likely to continue increasing. Even in the 1950's, there was remarkable product innovation in many industries—for example, 70 per cent of Procter & Gamble's sales volume in 1960 came from products introduced since the end of World War II.<sup>1</sup>

Although product change is evident in all industries, the *rate* of change varies widely. For example, the home sewing machine was invented in 1750, but the American market for it is still not nearly saturated—in 1960 there were sewing machines in only a little more than half of all U.S. households. Yet, television approached market saturation just ten years after its commercial introduction. Although few industries have experienced as rapid change as electronics, most of them are going through essentially the same process of product change. Most companies face the inevitable choice of product improvement and innovation or of gradually fading from the market. Such was the fate of most of the wagon and buggy manufacturers whose market gradually disappeared as the automobile replaced the horse. Yet, Studebaker, a wagon manufacturer, recognized the need for change and successfully shifted to the manufacture of automobiles, and more recently to other products as well.

**REASONS FOR PRODUCT CHANGES.** Is product change on such a vast scale necessary, or does it merely represent an attempt to artificially differentiate new products from old ones and from the products of competi-

<sup>1</sup> *Dun's Review and Modern Industry*, January 1961, p. 79.

tors? Many product changes may result from manufacturers' attempts to increase the rates of natural obsolescence so as to increase the demand in saturated markets. But, there are a number of other factors beyond the control of the manufacturer that make it necessary for him to update his products.

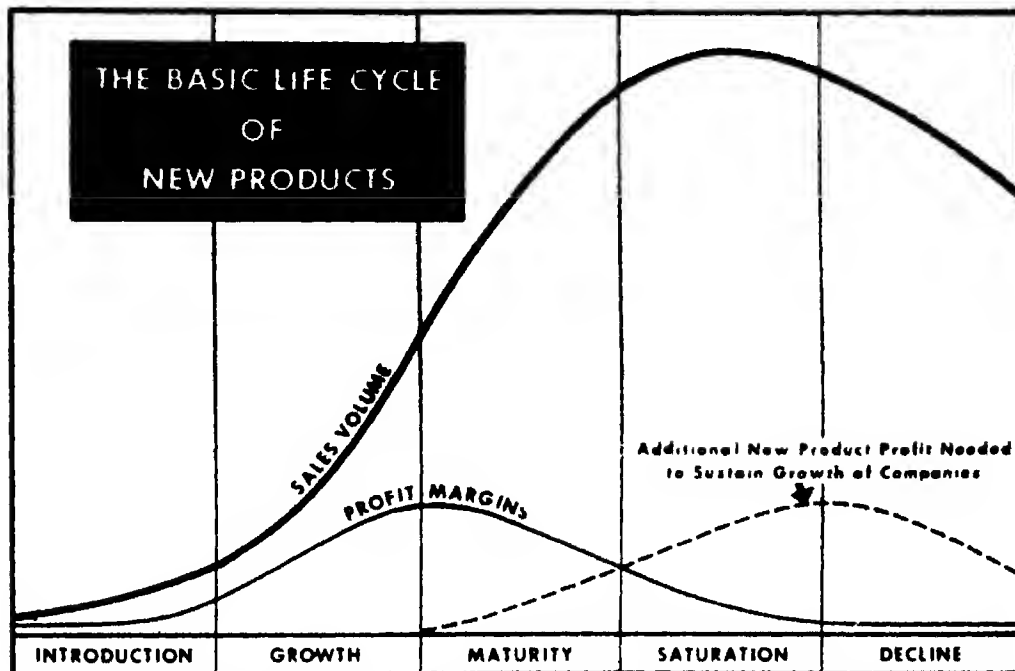
Changes in the market have made existing products and product lines inadequate. The increase in market segmentation—i.e., the subdivision of large markets into submarkets with unique needs—has decreased the likelihood that a single product can satisfy all consumers. The sophisticated modern buyer wants to feel that a product is tailored to his own needs and not to a mass market.

Changes in technology have broadened the markets for old products and made possible the creation of entirely new products. The transistor, which has replaced the vacuum tube in many appliances, is a case in point. It does not do anything that the vacuum tube did not already do, but because of its smaller size and weight, greater durability, and lower power consumption, it has brought about change in a variety of electronic products. Existing products, such as portable radios, received a big boost, and entirely new products became possible. Industry is spending vast sums of money on technical research today, and at an expanding rate, so technological change should continue to increase in importance as a cause of product change.

Profitless price competition provides another reason for introducing new products. When first introduced on the market, most durable goods that succeed in the market go through a normal curve of growth and decline in sales volume, as illustrated in Figure 16.1. The profit curve superimposed on the same chart reaches a stage of maturity and decline long before the maximum sales volume has been reached, because the entrance of competition into the field drives prices and profits down. Ultimately a point is reached where profits may almost or even completely disappear, even though sales volume is still very high. Companies with high overhead costs reach this unprofitable point soonest, because even a small reduction in volume drops them below the break-even point. Thus the firms spending the most for research find themselves having to continually develop new products to offset the declining profits on existing products. Consumer nondurable goods do not follow a sales life cycle. Since they are consumed rapidly, there is a continuing repurchase market. However, markets of nondurables reach saturation when there is no further opportunity to increase annual sales. Under conditions of market saturation there is a tendency toward the same type of profitless price competition described for durable goods.<sup>2</sup>

<sup>2</sup> For a description of market penetration and saturation for nondurable products see: Louis A. Fort and Joseph W. Woodlock, "Early Prediction of Market Success for New Grocery Products," *Journal of Marketing*, Vol. 25, No. 2 (October 1960), pp. 31-38.

Figure 16.1



Source: Management Research Department, Booz, Allen & Hamilton, *Management of New Products*, 1960, p. 6

A number of other reasons for introducing new products may or may not apply in any given firm. A company may develop new products to utilize the basic materials it is already making, or to utilize the waste or scrappage from present production. It may seek new products to even out sales fluctuations resulting from seasonal or cyclical factors, such as a line of water skis to balance out sales of snow skis. Similarly, it may seek new products to counteract the influences of highly erratic buying behavior by government buyers. A full line may be developed to make optimum use of distribution and production capacity and skills when they are not being used to capacity. In some instances, companies, as a result of mergers, acquire new products for purely financial and income tax reasons.

### *Inherent Dangers*

Many new product ideas are rejected as probable failures early in the development stage, and at a relatively small cost. But many new products actually reach the market before they are proven unsuccessful, and there is evidence that nearly half of new products put on the market never earn a profit.<sup>3</sup> The financial loss in such instances is very high. In a sense,

<sup>3</sup> *Management of New Products*, Unpublished research by Booz, Allen & Hamilton, 1960.

this cost falls most heavily on the companies that can least afford it since a larger proportion of the new products introduced by small companies fail to achieve profitable sales volume than do those of large companies. A primary reason for this *difference* is the superior organization and administration of product development in large companies.

#### *Alternative Product Line Policies*

Changes in the product or product line fall under three main categories: improvements in existing products, additions to the line of products, and deletions from the line of products. The introduction of a new model to replace an old model is an example of the first kind of product change. Scrambled product diversification (the addition of a product totally unrelated to the line), related product diversification (introduction of new products to provide a fuller product line), and similar brand multiplication (introduction of like products under different brands) are examples of additions to the line.<sup>4</sup> Simplification of the line by reducing the variety of models is an example of deletions in the product line.

**INTRODUCTION OF IMPROVED MODELS.** The successful producer is constantly striving to improve his products in order to improve his competitive position. The search for improvements in existing products is usually the most important responsibility of his research and development staff. To the extent that his research is successful in producing improved products, he improves his ability to capture a larger share of the total market.

Product improvement also provides a means of increasing the rate of obsolescence. This is most important in mature industries that have approached saturation of their markets. In such industries, a manufacturer is competing not only with other manufacturers in his industry, but with the products he and his competitors have already sold. If he depends solely on physical obsolescence, gradual wear, and deterioration, his future market is very limited. However, he can make existing products obsolete in two ways: by improving the performance characteristics of his product, and by changing the consumer's concepts of the acceptability of existing products. The introduction of automatic transmissions by the automobile industry is an example of the first type of created obsolescence, and the annual change in automobile body styling is an example of the second. Both forms of activity are normally described by the term planned obsolescence.

Planned obsolescence is a highly controversial topic. It is considered

<sup>4</sup> Taylor W. Meloan, "Plan Products for Future Growth," *Business Horizons*, Vol. 1, No. 3 (Summer 1958), p. 63.

economically wasteful by economists such as John K. Galbraith and popular writers such as Vance Packard.<sup>5</sup> Many business executives also oppose planned obsolescence, calling it "wasteful" and "contrary to the best interests of the country." The *Printers' Ink* executive panel voted two to one against planned obsolescence for this reason.<sup>6</sup> Yet, other writers and businessmen defended it as a necessary support to our high-level economy. Many industries in the United States would falter if planned obsolescence were suddenly eliminated. The ladies' garment industry might just as well shut down, and the automobile industry might be in almost as bad straits.<sup>7</sup> Supporters of planned obsolescence also point out that the criticisms are based on the moral judgment that a desire for the latest thing is wrong for society.

But planned obsolescence is not only controversial from the social viewpoint. Although it increases the potential market for producers and middlemen, it intensifies the problems of each. Each new model change results in high costs for new tooling and production shutdowns, as well as increased risk of poor consumer acceptance. Each change presents the middleman with the problem of liquidating old stock. Planned obsolescence should also be examined from the consumer point of view. To the consumer, creation of obsolescence through product improvement is generally acceptable, but changes in standards of acceptability of appearance are more controversial. Yet, fashion is not the creation of marketers. It has been a part of the western culture for many centuries, long before the coming of sales and advertising executives.

Although planned obsolescence is a fact of life for many producers today, and a regular part of their product policy, the regularity and frequency of product change varies among industries and individual concerns. Some producers prefer to change their products only when significant improvements justify the action. Others introduce new models on a regular, periodic basis, even though the changes may be superficial. The choice of these two alternatives usually depends on the practices of the industry, but not always. In competing in an industry as strongly committed to annual model changes as the American automobile industry, the Volkswagen has been marketed successfully under a policy of changing the product *only* when technological improvements justify it.

**ADDITIONS TO THE PRODUCT LINE.** Many product line additions result from some promising new product idea. Where do such ideas come from?

<sup>5</sup> The views of these two critics of planned obsolescence are presented in: John K. Galbraith, *The Affluent Society* (Boston: Houghton-Mifflin, 1958); and Vance Packard, *The Waste Makers* (New York: D. McKay Co., 1960).

<sup>6</sup> "Planned Obsolescence—Is it Wrong, Is There a Better Way?", *Printers' Ink*, May 26, 1961, p. 24.

<sup>7</sup> *Ibid.*, p. 31.



A company's own research and development work may produce some ideas, taking its direction from customer requirements or needs discovered through marketing research. Some companies, such as Eastman and du Pont, carry on programs of basic research and come up with products that were not specifically sought. Others get ideas from brainstorming sessions of management and other personnel, and from suggestions of salesmen, production people, engineers, and others. Still other ideas come from outside sources, both solicited and unsolicited.<sup>8</sup>

If the proposed product seems to have a potentially profitable market, careful consideration is given to adding it to the line. If it can be sold through the existing marketing organization, and will not require too large an investment in new productive facilities, the chances may be good of adding it to the line. Otherwise, the prospect of success must be very high to justify investment in new marketing channels or production facilities. A factor that may be important in determining the success of a new product is the appeal it is expected to make. In addition, if a product lies too far outside the experience of company management, the probable drain on executive time may be deemed too high. Some elements of newness are easily understood and readily accepted by consumers and aid speedy introduction of the product. Included in this category are aspects of the product that make familiar patterns of life easier, cheaper, and otherwise more pleasant. But other product aspects require new patterns of life, new habits, the understanding of new ideas or viewpoints, acquisition of new tastes, and acceptance of things that are difficult to believe. When products incorporate such new ideas, a maximum of marketing effort is required to overcome the reluctance to accept the new ideas.<sup>9</sup> It is sometimes necessary to add new products to a line even though their potential direct contribution to profit appears to be small, because of the desire to offer a complete product line. When consumers prefer to buy from those manufacturers' lines that offer a complete range of selection, the increase in profits on the more popular items in the line may more than compensate for the losses on other products.

Diversification of risk offers another reason for the addition of new products. The threat of obsolescence hangs over the most stable products: the buggy was replaced by the automobile, and even the once stable fountain pen has been badly hurt by the ball point pen. The greater the variety of products produced by a firm, the smaller the relative contribu-

<sup>8</sup> Richard R. Still and Edward W. Cundiff, *Sales Management: Decisions, Policies, and Cases* (Englewood Cliffs, N.J.: Prentice-Hall, 1958), p. 381.

<sup>9</sup> Chester R. Wasson, "What Is 'New' about a New Product?" *Journal of Marketing*, Vol. 25, No. 1 (July 1960), p. 56.

tion of each to profits, and, thus, the smaller the relative impact of its disappearance from the market.

**PRODUCT LINE SIMPLIFICATION.** Reduction in the number of products and models in a product line offers an excellent opportunity for cost reduction since product multiplicity results in high inventory and selling costs for retailers and wholesalers, and dilutes the impact of the promotional budget. Marketing men generally favor offering a broad variety of models of their products, because this simplifies their problem of satisfying the widely varying needs of their market. Production men, however, like to keep product lines simple, since this keeps production cost down and makes their job easier. Henry Ford's Model T exemplified the production viewpoint since it offered practically no variety of selection or choice. But in the competition for today's markets, manufacturers have been forced to offer greater and greater variety in their lines; the increasing sophistication of the consumer, and the division of the market into segments, have contributed to this multiplicity of products. However, this trend must stop somewhere, or it will, in effect, lead to custom production—with its inefficiency and high costs. Simplification should always be an objective of the product manager or merchandiser.

#### *Product Line Decisions*

In our dynamic business environment today, the most important product line decisions are those relating to the acceptance of and preparation for change: the introduction of new products and the abandonment of existing products. Decisions are also necessary on selection of market segments; variety of models, colors, and sizes; desired share-of-the-market; and product line expansion.

**ADJUSTMENT TO CHANGES IN MARKETS AND PRODUCTS.** Changes in the market, whether long-range or short-range, require management decisions on when to enter and when to leave the market. A manufacturer who pioneers in introducing a new product assumes the high costs of helping to create a primary demand, in addition to research and development costs. Against this he must balance the short-run opportunity for an extra-high gross margin and the opportunity to get ahead of competitors, to determine whether such action is potentially profitable.

Virtually every product is capable of being improved in some functional aspect and, of course, products can also be "improved" through design and packaging innovations. In considering whether to go ahead with such improvements, management should compare the likely addition to marginal revenue against the associated additions to cost. If

probable marginal revenue exceeds the marginal costs involved, management should go ahead with the product improvement. If, however, costs exceed the expected revenue, the matter should probably be set aside for reconsideration at a later time. In estimating marginal revenues and marginal costs, management should certainly make use of information gathered through research. Research can be directed, for example, to determine, for a product class, relative sensitivity of consumer response to different types of innovation ranging from major functional change to minor design change.<sup>10</sup>

Product innovation will ordinarily follow a series of steps from the origination of the new product idea to market introduction and evaluation. One summary of this developmental process includes seven steps: (1) The idea; (2) rough estimate of the market; (3) formulation of the product design; (4) development of the marketing strategy (including selection of brand name, channels of distribution, and selling strategy); (5) test marketing; (6) full-scale market introduction; and (7) follow-up evaluation.<sup>11</sup> The high cost of product development and introduction makes it important to discard unpromising ideas as early as possible in the development process. For this reason, it is important to provide for formal screening of product ideas after each of the development stages. At certain stages this screening may be only a rough analysis of the facts; at other stages it may involve highly objective evaluation. But at all stages a conscious decision is required—to continue or to cancel.

Each new product should be subjected to exhaustive evaluation before spending the large sums of money necessary to tool up for production and to develop a new market. Several approaches have been suggested to increase the precision of such an evaluation by quantifying the analysis, one making use of the evaluation matrix described below.<sup>12</sup> This matrix is designed to measure profitability and success, and it involves a two-part analysis. The first step involves ranking and weighing various spheres of company activity. These activities are shown in the matrix, Figure 16.2 (below), and they represent the spheres in which successful performance is a function of the extent and nature of company capabilities. The weights assigned to each sphere are shown in column "A" of the matrix. The second step shows the degree to which the product is compatible with each of these spheres by assigning to each a value from

<sup>10</sup> L. L. Howell, "Planned Innovation as a Marketing Tool," *California Management Review*, Vol. 4, No. 4 (Summer 1962), p. 69.

<sup>11</sup> Edmund W. J. Faison, "The Application of Research to Product Development," *Business Horizons*, Special Issue on the First International Seminar on Marketing Management (February 1961), pp. 37-38.

<sup>12</sup> Barry M. Richman, "A Rating Scale for Product Innovation," *Business Horizons*, Vol. 5, No. 2 (Summer 1962), pp. 37-44.

0 to 1.0 as shown in column "B." A product that fitted company needs and objectives perfectly would receive a final score of 1.0. The product evaluated in the matrix in Figure 16.2 received a score of only .720—in the "fair" range. With an objective basis for product evaluation, such as this,<sup>13</sup> a cutting, or minimum-acceptance, score can, on the basis of experience, be established to provide a basis for automatic rejection of the more unpromising ideas. In addition, it provides a basis for selecting the most promising idea from among several, when limited resources make it impossible to exploit more than one new product.

Figure 16.2  
Evaluation Matrix—Product Fit

Sphere of Performance	A Relative Weight	B Product Compatibility Values										C A × B	
		0	.1	.2	.3	.4	.5	.6	.7	.8	.9		1.0
Company personality and goodwill	.20							x					.120
Marketing	.20										x		.180
Research and development	.20								x				.140
Personnel	.15							x					.090
Finance	.10										x		.090
Production	.05											x	.040
Location and facilities	.05				x								.015
Purchasing and supply	.05											x	.045
Total	1.00												.720 *

\* Rating Scale: 0-.40, poor; .41-.75, fair; .76-1.0, good. Present minimum acceptance rate: .70.

Source: Barry M. Richman, "A Rating Scale for Product Innovation," *Business Horizons* Vol. 5, No. 2 (Summer 1962), p. 43.

Once the decision has been made to add a new product, timing becomes critical. Ideally, a producer would take the time to perfect his new product and his marketing plans before entering the market. Careful market analysis would allow him to fit the product perfectly to consumers' tastes and needs, and to develop a marketing mix with the best price, the best channels of distribution, and the best promotional program. But a producer may not have the time for such careful planning. The firm whose product is first on the market may gain certain advantages, and it may take a very powerful marketing program to overcome such an initial edge. Because of such a threat, management may

<sup>13</sup> For a description of a somewhat more complex evaluation procedure see: John T. O'Meara, Jr., "Selecting Profitable Products," *Harvard Business Review*, Vol. 39, No. 1 (January-February 1961), pp. 83-89.

be strongly tempted to enter the market too quickly. A careful consideration of all pertinent factors will increase the chances that the decision to enter the market will be early enough, but not too early.<sup>14</sup>

Another factor affecting the decision to introduce a new product is the possibility of strong price competition. The extent to which price competition will develop in the market for an established product depends on consumers' replacement rates and the extent to which competing products can be differentiated to the consumer. The decision to introduce a new brand of a consumer convenience good such as soap would be based primarily on management's assessment of its opportunity to differentiate its product, and access to financial resources sufficient to carry on a program of demand creation for its brand. The decision to manufacture a product such as transistors, after the initial phase of market expansion, would depend on management's assessment of its ability to compete profitably on a price basis.

The decision to abandon a product (or an entire line) often results from changes in the market. Market saturation may cause a producer with high overhead costs (e.g., research and development costs) to stop producing an item that becomes unprofitable because of price competition. Products may also be abandoned, even though still profitable, if management believes that the same resources could yield a higher profit from other products.

Many product line decisions result from product obsolescence, which may come about naturally as a result of the development of new or improved products, or as the result of a predetermined policy. Natural obsolescence requires decisions both on the abandonment of products and the addition of new products to replace them so as to protect sales volume and profits. The decision on whether to produce a new product is only a part of the problem; timing is also important. When ball point pens were first introduced, manufacturers of fountain pens were faced not only with the problem of whether or not to make ball point pens, but when such action should be taken. They had no way of knowing at the time that this new pen would almost eliminate the fountain pen. Ideally, they would want to introduce the new product in time to compensate for any expected loss in sales volume on fountain pens. Quantification of such a decision is nearly impossible because of the necessity of forecasting consumer reaction to an unknown and untried product.

Another product line policy requiring management decisions is the creation of obsolescence through a program of regular model changes. The decision to adopt a policy of planned obsolescence will generally

<sup>14</sup> Seven factors affecting the time of entering the market are listed and discussed in: Robert E. Weigand, "How Extensive the Planning and Development Program," *Journal of Marketing*, Vol. 26, No. 3 (July 1962), pp. 55-57.

depend on industry practice, although in some industries where the policy on this matter is fairly uniform, individual firms (e.g., Volkswagen in the auto industry) have managed to operate profitably under a contrary policy. Additional problems in this regard involve decisions on the frequency of model changes, and on timing the introduction of new models. Such decisions should be based largely on estimates of comparative production and distribution costs and comparative sales volume potentials, but they have to be modified by such intangible considerations as dealer morale and profits, sales force motivation, and public relations in general. In fact, even the possible reactions of labor unions must be taken into account in setting the dates for introducing new products, inasmuch as union leaders sometimes think of these dates as strategically ideal for delivering decisively timed blows against producers.<sup>15</sup>

**SELECTION OF MARKET SEGMENTS.** Since a single product is rarely able to fill the needs of all segments of the market, the logical product-line policy is to select the segment (or segments) offering the largest potential return, and to produce a product (or products) to satisfy the needs of these segments. The important elements in such a decision are fairly objective, and we may express it in terms of a formula, as follows:

$$(S \times B \times P) - C = N$$

- where, S is the size of the market segment
- B is the buying potential per consumer
- P is the projected share of the market
- C is the differential (or special) cost of reaching the segments
- N is the differential (or extra) profit.

The projected share-of-the-market and the differential cost of reaching the market segment are interrelated since cost can be affected by the share sought. For instance, as a company seeks to expand its market share from 40 to 60 per cent, the costs of capturing this additional 20 per cent of the market are proportionally greater than those incurred by the same company in expanding its market share from 20 to 40 per cent. This may have been the sort of reasoning that led the Coca Cola Company to seek a share of the lime-lemon drink market through the introduction of Sprite, rather than trying to increase its already large share-of-the-market for cola drinks.

**VARIETY OF MODELS, COLORS, AND SIZES.** Increasing the variety of selection by adding models, colors, and sizes increases the size of the market

<sup>15</sup> T. L. Berg, 'Union Inroads in Marketing Decisions,' *Harvard Business Review*, Vol. 40, No. 4 (July-August 1962), p. 68.

that can be potentially satisfied. But it also increases production and marketing costs. Production costs are increased because of shorter production runs and more complex scheduling; marketing costs are increased through higher inventory costs and reduction of turnover at all levels of distribution. Decisions as to the variety of selection should be based upon an incremental profit analysis. The estimated increase in costs, both production and marketing, should be compared with expected increases in sales volume to determine whether the proposed change will increase or decrease profits. The aim in each instance should be to achieve the optimum variety of models, colors, and sizes, whether this would be achieved by simplification of the line, or by additions to it.

**PRODUCT LINE EXPANSION POLICIES AND DECISIONS.** When, in the minds of consumers or users, several products are classified as a related group or line, management must decide whether or not to produce a complete line. Such is the case with kitchen and laundry appliances. Consumers seek these items in the same types of retail outlets, and are sometimes looking for more than one appliance at the same time. The individual manufacturer's decision to manufacture only one kind of appliance, or to manufacture a complete line of appliances, should result from an evaluation of a number of factors. First, he must be financially able to add new products. Second, he should analyze the probable effect (of adding to the line) on the profits on his existing products. If he finds that a large number of consumers prefer to buy matching appliances, a more complete line will increase the potential sales volume of his present products. At the same time, as he broadens his line, the marketing costs per category of products should be reduced, since little more promotion or selling effort may be required to sell the line than to sell a single appliance. Against these potential gains must be balanced the probability of success for the new products. Does the company have the production, engineering, and general management "know how" to develop and produce new products as good as its present products? Third, management must evaluate the effect of the new products on the reputation of established products. If consumers consider a new product inferior to the products already in the line, it is possible for the reputation of the entire line to be damaged.

Another method of product line expansion is diversification into unrelated product categories to provide a hedge against short-term or long-term changes in the demand for present products. Although such decisions may involve entry into entirely new lines of business, it is often possible to utilize at least part of existing talent and resources. New products may be selected to utilize the marketing channel and organizational structure. Careful analysis of production and distribution costs

and management resources in each area should help to reveal the more promising direction for product diversification.<sup>16</sup>

The case of the Warner and Swasey Company shows how one industrial goods company pursued a product diversification program. This firm was, up to the end of World War II, an old and well-established maker of turret lathes. The productive capacity of the firm was greatly expanded during the war, and management set up a postwar planning committee in 1943 to study product areas (allied to machine tools) which the company might enter. The search for new products was confined to those that could be sold directly to industrial users by the existing sales force. In addition, the committee used three criteria to help guide their selections of new products: (1) the product should be one to which company facilities, experience, and workmanship would be readily adaptable; (2) the product had to be one which would require and readily emphasize engineering skill, excellence of design, and accuracy of manufacture; and (3) the product should, if possible, assist in smoothing out the violent economic cycles so typical of the machine tool industry. Applying these criteria led to expansion into a broad line of machine tools and diversification into the field of textile machinery. By 1958, approximately 65 per cent of Warner and Swasey's sales came from products not in existence just twelve years earlier, that is, just after the war.<sup>17</sup>

#### STANDARDS OF PERFORMANCE AND SERVICE

Since it is essential both to mass production and mass distribution, standardization of products and services has become an integral part of modern business. It provides the consistency and predictability in product performance that is essential to brand differentiation. Consumer brand loyalty is based on the expectation that each article sold under a particular brand name will be like all others with the same brand name. Thus, marketers are not seriously concerned with whether or not to establish standards, but rather with what aspects of products and services to standardize, and what standards to establish. Important management decisions on standards policy include product specifications, product quality, and product service.

#### *Product Specifications*

Product size is usually the result of a marketing decision, and the marketing expert is best qualified to decide the optimum size of such prod-

<sup>16</sup> For an interesting discussion of a sophisticated method suggested for use in deciding among alternative diversification possibilities, see: H. I. Ansoff, "Strategies for Diversification," *Harvard Business Review*, Vol. 35, No. 5 (September-October 1957), pp. 113-124.

<sup>17</sup> R. A. Kelly, "The 'Unimportant' New Line that Remade Warner and Swasey," *Sales Management*, October 2, 1959, pp. 87-88.



ucts as brooms, towels, or even sticks of gum. For many products, the unit size has been firmly established by custom, but even here consideration may profitably be given to changes in size, or to the addition of new sizes.

Several factors enter into the determination of product size. Most important is consumer needs. Thus, when aspirin was first put on the market, tablet size was necessarily based on consideration of normal dosages, minimum dosages, and a size small enough to achieve these dosages with multiples of a single tablet. Subsequently, when competitive firms entered the market for aspirin, tablet size had in effect become standardized, so no attempt was made to change it. The determination of consumer needs with respect to product size requires the evaluation and weighting of a number of variables. Each of the variables which help to create market segmentation may affect the size requirements for certain products. For example, when baby aspirin was introduced (to reach that age segment of the market), it was deemed advisable to introduce a smaller size of tablet. Even with a product such as aspirin, which appeals equally to many market segments, the task of determining product size will provide different answers under different conditions, as illustrated by French aspirin. French aspirin manufacturers, approaching this problem of tablet size independently, developed aspirin tablets considerably larger than American manufacturers. Yet, in this instance, consumer needs vary little if at all between the French and American markets.

Size range and variation will be affected by inventory costs and stockturn, both for middlemen and for the manufacturer. This is particularly true with products such as clothing, where the range of sizes is large. Although the needs of consumers may dictate a very large range of sizes, the costs of maintaining inventories of the more extreme sizes, and the low stockturn on such sizes, may make it advisable to restrict the offering of sizes to the middle range.

Industry-wide standardization also affects company policy with respect to size. In industries where standardized product specifications have already been established,<sup>18</sup> most firms will probably find it to their advantage to adopt these standards because of the favorable effect of such action on consumers and middlemen. The consumer's buying job and the middleman's buying and selling job are both greatly simplified if they know that all men's socks in size 10 are exactly the same size

<sup>18</sup>The Commodity Standards Division of the U.S. Department of Commerce helps industry groups to establish physical standards when such action is considered to be in the public interest. The Division sponsors industry conferences to promulgate tentative standards and then circularizes all groups concerned for approval. Such approved commercial standards are used by members of the industry on a voluntary basis.

and need not be measured or tried on. Against these factors must be weighed the reduction of product differentiation and the increase in substitutability of competitive products and parts. (Analysis of these same factors will affect management's decision to encourage or discourage the establishment of uniform standards in industries where they have not yet been used.)

Other product characteristics, such as basic weights and measures, performance standards, and chemical or technical properties, are selected in essentially the same manner as size. Each decision should result from an evaluation of consumer needs, comparative distribution costs, and industry practice.

### *Product Quality*

Producers of most manufactured goods have wide latitude in determining the quality of their products. With products of the farms, forests, fisheries, and mines, little control can be exerted on quality. The main concern of producers of such products is to define quality by grading. Even for some manufacturers, the limits of control over quality are narrow. For example, a chemical manufacturer cannot change basic compounds, so he can affect quality only in terms of absence of foreign elements, i.e., purity. Most manufacturers, however, have a wide latitude in establishing policies on product quality—durability, uniformity, reliability, and other such characteristics.

In its simplest terms, quality may be expressed as a function of price. Thus, if the price of a product is high, the quality can also be high, and if the price is low, the quality can also be lower. However, this is an oversimplification and ignores the effect of demand creation activities. It has been repeatedly demonstrated that products can compete successfully, at the same prices, against similar products of a higher quality—providing that the lower-quality product is promoted better. Examples of this can be found among private brands of canned fruits and vegetables, which are often better values than nationally advertised brands because they offer equal quality at lower prices. However, demand creation will not compensate for really large quality differentials. The effectiveness of the distribution organization may also influence the impact of quality differentials. It is sometimes economically impossible to introduce a new product of superior quality, even at competitive prices, in competition with products already enjoying strong demand and good reputations with middlemen.

To the extent that price is a factor in determining quality, management should make its quality decisions in terms of the factors affecting price, particularly those of demand and supply. Price decisions, and hence quality decisions, will be made as a result of analyzing the nature

of demand and competition at varying price levels. (Quantitative approaches to pricing decisions are discussed in Chapter 18. These approaches are based on the assumption that quality is held constant in determining optimum price, but optimum quality may be determined in the same manner by holding price constant.)

Obsolescence is another limiting factor in making decisions on product quality. A high rate of product obsolescence will tend to set an upper limit on quality, at least to the extent that quality affects durability. Consumers may be unwilling to pay more for a refrigerator designed to last for 20 years, if it appears certain that it will become obsolete in a considerably shorter period of time because of the introduction of new design and operating features.

#### *Product Service*

By their very nature, many products must have policies set with respect to services offered both by manufacturers and middlemen. For example, most mechanical products require periodic maintenance and repair, so arrangements must be made to see that such services are available. One such service is product adaptation or redesign to meet the special needs of particular purchasers. The decision to offer such a special service should be based on an evaluation of two factors: the public relations and promotional value of these services in terms of the entire product line, and the expectation of profit from the sale of the specially designed products. When it appears likely that the designing of a special product for a particular purchaser will induce him to buy large quantities of the manufacturer's standard products, any expected loss on the special transaction can be rationally justified as selling expense. When special orders are profitable in their own right, the decision to accept them may be a simple one, but it is necessary to include a charge for the time of executives and engineers in making the profit-analysis, since their time could have been otherwise used. With the final decision to accept special order sales, a general policy should be set regarding the desirability of equal treatment to all customers. If the acceptance of a few profitable special orders is likely to result in requests for many unprofitable orders, management should only adopt a special order policy if it deems it wise to maintain different services for different customers.

Many producers of complex products must decide whether or not to provide installation and repair services to their customers. When the product is very complex (e.g., computers and data processing equipment) it may be clearly necessary to provide these services, but for many products the situation is not as clear-cut. It was for this reason that many appliance manufacturers were reluctant to sell through discount houses, since these retailers do not provide the customer with such

services. When the manufacturers discovered, to their surprise, that many consumers were willing and able to take care of both installation and servicing on their own, the opposition to discount houses decreased. Those manufacturers who were slow to recognize that they had overestimated the importance of installation and repair services by the retailer lost contact with an increasingly large proportion of their potential market as the discount houses rapidly expanded. In the final analysis, the decision to offer these services should be based on an appraisal of the customers' needs.

### **PACKAGING DECISIONS**

The decision on whether to package a product is based on consideration of two factors: the need for product protection, and the need for product differentiation and identification. A product such as coal needs no protection against damage from the elements and handling, whereas photographic film requires protection from exposure to light. Although these are extreme examples, the need for packaging to protect the product is usually just as clear. If a product is packaged for purposes of identification and brand differentiation, it should remain in the package until the consumer buys it. Thus, bulk packaging that is removed before the consumer or user buys is solely for protection or convenience in handling. For example, five-pound bags of sugar arrive at the supermarket inside a large paper bag containing ten or twenty of the smaller bags designed for brand identification. The decision to package for identification purposes depends on the product. When the brand name can be placed directly on the product, as in the case of appliances, there is no need for packaging at the point of sale. Also, if the product cannot be successfully differentiated to the consumer, as is the case with nails and nuts and bolts, there is no justification for packaging except to increase consumer or middleman convenience. U. S. Steel now packages these products to increase the ease of handling in self-service stores.

Once a manufacturer has made the basic decision to use packaging, he must make a number of additional decisions on package design, size, and cost. When packaging is used solely for protection, these decisions are primarily technical and are relatively less difficult than when the package acts as a promotional tool, and the decisions involve consumer motivation.

#### ***Package Design***

When packaging is primarily protective, design decisions are technical, involving comparative strengths and costs of materials and shapes. But when a package is primarily a promotional device, decisions are necessarily more subjective. Promotional elements in the package must at-

tract consumers' attention, hold their interest, and build their desire to buy. The color, size, and shape of the package are all important in attracting the consumer, so decisions on these factors should be related to the preferences of the desired market segment. The promotional aspect of package design is becoming more important each year as more and more products are being sold in self-service retail outlets. In these stores, the package must carry all of the promotional burden it formerly shared with the sales clerk.

Package design must also consider convenience in product handling, both by the middlemen and the consumers. The shape of the package should permit easy display on the fixtures in the normal retail store. It should make it easy for the consumer to take the merchandise home and to store in his normal storage cupboards. The six-pack carrying-carton for beer and soft drinks is an excellent example of a package that greatly increases ease of handling, and at the same time increases consumption by encouraging an increase in the unit of purchase.

#### **Package Size**

The package size decision evolves from the consideration of several factors: the two most important are the size of the consuming unit, and the rate of consumption—and they are closely interrelated. Cigarettes, candy bars, and toothbrushes are consumed by individuals and are packaged in units for individual rather than group consumption. Cake mixes and gelatin desserts are consumed by household or family units and are packaged for group consumption. Dry breakfast cereals are packaged both ways: by family boxes and individual serving packs. Statistics are available on the average sizes of families, and on their distribution by size. The producer may simply decide to package his product in a size to satisfy the average family, or he may provide several sizes so as to satisfy a broader range of family size. Having decided on the size of the consuming unit to be served, the manufacturer must then determine the rate of product consumption by each unit. How much gelatin dessert does a family consume at a sitting? How many cigarettes does the average smoker use in a day? Consumer tests and surveys are useful in providing answers to such questions.

Findings on the consumption unit and the rate of consumption sometimes have to be modified when custom or habit strongly influence the package size. For example, the housewife is so accustomed to buying butter in one pound units that it would be very difficult to change to an unrelated unit, such as the pint or quart. She has learned to compare prices on the basis of pounds of butter, and would probably be reluctant to buy in any other unit of measure.

Customary prices may also influence the package size. Several manu-

facturers of five-cent candy bars found it easier to reduce the amount of candy in each package than to raise the price when rapidly increasing costs dictated such an action, shortly after World War II.

Package size may also affect total consumption of a product. When the consumer has a plentiful supply of a product on hand, he may consume more than if he has to make a special buying trip to obtain it. The six-pack carton for soft drinks and beer and multiple packaging of light bulbs have demonstrated the success of this approach. The same holds for large economy-sized packages.

#### **Package Cost**

The amount of protection necessary to deliver a product to the user in good condition dictates the minimum cost of the package, but consumer preference and convenience may make it advisable to exceed this minimum. Although a metal container may be less expensive, a glass container may be used because of strong consumer preference for glass with certain products. Similarly, a reclosable package, although more expensive than a throw-away package, allows the customer to store the product easily until it is all used without the necessity of transferring it to another container. Each such addition to the basic cost of packaging should be justifiable in terms of its probable effect upon consumer demand.

When a package is used for brand identification and promotion, the cost of achieving these goals is properly considered a part of the total promotional mix. Sometimes, this cost differential may be very small over the long run. In any case, descriptive information must ordinarily be provided on the package, and once the cost of designing an attractive label has been paid, the cost per package may be almost unchanged. However, a purely promotional container, such as an expensive perfume bottle, can increase packaging cost several times, and this cost differential is clearly a promotional cost. Similarly, reusable, dual-purpose packages are selling devices, and their costs should be justifiable in terms of their effectiveness in increasing demand for the product.

#### **BRAND DECISIONS**

Brand identification is a necessary policy for the producer who wishes to exercise maximum control over the demand for his products, and to be able to compete on nonprice bases. The truck farmer raising peas must compete with other farmers for his share-of-the-market almost solely on a price basis, since the consumer does not know or care who raised the peas he buys. Yet, the food canner is often able to build a strong consumer loyalty for his products by persuading consumers that they are different from those of competitors.

Most products that lend themselves to brand identification and dif-

ferentiation are branded in the American market today. But there are some products which simply cannot be differentiated in the eyes of the consumer. Products of the farm, forests, and mines are among those that are difficult or impossible to differentiate because of their unprocessed form,<sup>19</sup> but there are highly standardized manufactured products, such as sheet steel and nuts and bolts, which also cannot be effectively differentiated. However, there are many products where the effectiveness of brand differentiation is not clear, and it is in these instances where the choice to brand or not to brand is an important managerial decision. For example, 15 years ago most marketing experts believed that brand differentiation was wholly ineffective for women's dresses because women bought on a basis of factors unrelated to brand, such as color, design, styling, and fit. Today, however, brand names have become an important factor in the dress industry, because manufacturers discovered that variations in size and shape of the customer not provided for by differences in standard size dresses, gave them an opportunity for real product differentiation. Thus, the short-waisted woman can eliminate the expensive alterations normally required when she buys a new dress because she has found that brand XYZ dresses fit her without alteration.

Ultimately, the decision to use or not to use brands depends on the ability of management to truly differentiate the product in question, and, if it is to be helpful in creating brand recognition, this differentiation must be in terms of characteristics that are important to the consumer.

#### *Family Brands vs. Individual Brands*

When a company sells more than one product, it must decide whether to market each under a separate brand, or to use a common family brand for all products. Each way has its advantages and disadvantages, and management should consider these in making its decision.

All products do not lend themselves to sale under a family brand. Unless different brands represent broadly different price ranges, such as General Motors' Chevrolet and Cadillac, the quality of family-brand products should be very nearly similar, so that no single product in the line can lower the quality reputation of the other products. Otherwise, consumers will tend to equate all products sold under the same brand. They will expect Del Monte canned peas to be as good as Del Monte peaches. The products should also be fairly compatible. Although a housewife may prefer a particular brand of soap, she will probably not be at all interested in a new brand of perfume introduced under the same name, because she is not convinced that experience in manufacturing soap will carry over to the manufacture of perfume. The products

<sup>19</sup> There are a few notable exceptions, such as Sunkist citrus fruits and Black Diamond walnuts.

to be branded should also be sold to the same markets. There is little to be gained from applying a family brand to one product sold to industrial users, and to another product sold to ultimate consumers; the same situation applies between smaller market segments. The name *Serutan* would have no value (probably negative value) on a product marketed to teenagers.

The decision to use a family brand is sometimes an unconscious one, for when a new product is introduced, it may simply be sold under the existing brand name without any serious consideration to the use of a new name. But if management wants to make a rational choice between individual and family brands, the decision will result from the evaluation of the following factors.

**NATURE OF THE PRODUCT LINE.** Similar products which are naturally related to each other in the minds of consumers such as sheets and towels, can benefit particularly from the use of a family brand. Favorable reaction to one product will often lead consumers to use other products in the line. However, this "halo" effect can also detract from a manufacturer's reputation since unfavorable experiences with one product may turn consumers against the entire line. It is important, then, that particular care be taken that all products under the family brand conform to consumers' standards of acceptance. Products that lack common marketing attributes are usually better marketed under individual brand names, since little if any benefit is likely to be derived from jointly associating them. There may even be adverse sales reactions. For example, the association of food products with a known brand of soap products may handicap sales of the food line because consumers generally associate an unpleasant taste with soap.

**PROMOTIONAL POLICY.** The use of a family brand requires a smaller total promotional budget than do individual brands. Under a family-brand, much of the promotional effort can be directed toward the entire line, and even those promotional programs that concentrate on a single product still help to increase recognition and demand for the entire line. With individual brands, independent and often duplicating promotional programs are usually needed for each product. Thus, a family-brand policy ordinarily allows the most effective use of limited promotional funds for similar products. Yet, such joint promotional programs limit the opportunity to emphasize individual product differences, and this may be a very important goal when introducing a new product.

**DESIRED MARKET PENETRATION.** Individual products in a line face varying degrees of competition in the market. For example, a producer



of a broad line of kitchen and laundry appliances may meet only mild competition on dishwashers and electric ranges because his competitors are not promoting these products any more successfully than he is. At the same time another competitor producing only washing machines and promoting them aggressively may have captured a large share-of-the-market and may be extremely difficult to displace. In such instances, where it is impossible to achieve the same degree of market penetration for all products, the use of individual brands allows greater promotional flexibility. The products which face the strongest market competition may be allowed larger shares of the promotional budget so that optimum market penetration can be achieved for each product in the line. This will also make it easier to draw consumers' attention to changes and improvements in individual products. The use of individual brands also allows a producer to achieve greater market penetration by marketing similar but differentiated products to appeal to different segments of the market.

#### *Multiple Brands for Identical Products*

Producers of specialty goods often market their goods through a limited number of selected retail outlets in order to gain their dealers' cooperation in aggressively promoting the products. This policy is called "selective distribution" (discussed in detail in Chapter 17) and has the effect of limiting the total potential market, since in any one market no single retailer or small group of retailers is normally in a position to attract all potential buyers. It should be pointed out, however, that even with a selective distribution policy, market penetration may be increased by offering identical merchandise under a different brand to a second group of selected retailers. The Hickey-Freeman Company does this by distributing a second brand of men's clothing, the Walter-Morton brand, in addition to its Hickey-Freeman brand in trading areas where more than one retail outlet is deemed desirable.<sup>20</sup>

Mergers frequently result in the use of multiple brands (at least on a temporary basis), the merged company often ending up with two or more identical or nearly identical products selling under different brands. The decision to retain the separate brands or to change to a single brand may depend on several factors. If the different brands have developed dissimilar images that appeal to different segments of the market, the decision may be to leave things as they are. If each of the brands has developed strength in different regional markets, management may be reluctant to abandon well-known names for others that, at least in some markets, may be unknown. Such was the case with Standard Oil-Company of New Jer-

sey, subsequently renamed Humble Oil Company, which used the ESSO brand in the northeastern part of the United States, and different brands in several other regions of the country. Their decision was further complicated by the fact that under the court ruling (*Standard Oil Co. vs. U.S.* 221 U.S. 1, 1911), that dismembered the Standard Oil monopoly and created Standard of New Jersey and five other companies, the ESSO brand was barred from use in certain regions. Reluctant to abandon the ESSO name, its most important single brand, management decided (1961) to retain the ESSO brand in the northeastern region, and to adopt an entirely new name, ENCO, to gradually replace all of its other regional brands. The reasoning was that two brands (ESSO and ENCO) that could become well-known regionally would be better than a number of brands.

#### *Use of Private Brands*

Private brands are those owned and controlled by middlemen rather than by manufacturers. Both manufacturers and middlemen may be faced with policy decisions on private brands. Manufacturers may have to decide whether it is advantageous to manufacture products for sale to middlemen for private branding. And middlemen quite often must decide whether they can gain by developing brands of their own.

Several factors may affect a manufacturer's decision on the acceptance of private brand orders. First is the probable effect on the sales of his own brand, if he owns one. Can the private brand be clearly differentiated from his own brand, or will consumers accept them as the same? And even if the private brand is adequately differentiated, will it merely capture a share of the total market from his own brand? When the total market is limited and it is unlikely that the middleman will be able to find another source of supply, the decision will probably be to reject the order. But when the market is large and the middleman is almost certain to be able to find another supplier, the decision to accept the order should be based on expected profitability. Acceptance of private brand orders as a source of potential profit is primarily a financial and manufacturing decision, except to the extent that it may affect costs and prices of the controlled brands.

The Whirlpool Corporation is an example of a firm which has successfully sold both under its own trade name and a private brand. Approximately half of its production of washing machines is sold under the Whirlpool name and half under the Kenmore name, owned by Sears, Roebuck. Selling under these two brands, the company ranked in 1959 as the leading producer of home laundry equipment. Whirlpool management, although glad to have Sears as its major customer, is also glad to have a strong national market under its own name, and other major

customers such as Montgomery Ward and Frigidaire (for whom it produces commercial ice makers).<sup>21</sup>

A middleman's decision to promote private brands of his own will be based on expectation of greater profits and expectation of greater control over the market. In evaluating the possibility of increasing profits, he must balance the higher margin from the private brand against the increased costs involved in advertising and promoting it. To the extent that a middleman can create a strong consumer loyalty for his own brand, he increases his own control over the market. His demand creation efforts will not benefit other middlemen, since his outlets constitute the only source of supply, and he does not have to worry about the loss of his franchise at the brand owner's whim.

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<sup>21</sup> "Own Lines Help Whirlpool Market a Doubled Volume," *Sales Management*, February 6, 1959, p. 41.

### CONCLUSION

In the rapidly changing modern business world, product improvement and innovation are necessary to long-range marketing success. Product line decisions are a continuing responsibility of management. Standards of performance and service help to delineate the market segments to be served by each product; although decisions in this area are not subject to the constant change of product line policies, they should be periodically reviewed. Packaging and branding decisions are closely related to the promotional policies and decisions, and are subject to review whenever these policies are changed.

### QUESTIONS AND PROBLEMS

1. What were the flaws in Henry Ford's reasoning that if you build a basically good product like the Model T, people will continue to buy it? Would the same reasoning apply to the Rolls Royce automobile?
2. If the innovating company with high research and development costs suffers first from market saturation and price competition, is it not better policy for a company to be a follower? Discuss.
3. The term "planned obsolescence" has acquired a negative connotation, yet it actually has important positive aspects. Please explain.
4. Is there planned obsolescence in the Volkswagen automobile? Explain.
5. How can you explain the seeming lack of consistency in pro-

posing that a firm seek to make new additions to its product line and also to work toward simplification of the product line?

6. "Ideally, a producer would take the time to perfect his new product and his marketing plans before entering the market." Is the producer normally able even to approach this ideal? Why?
7. Increasing segmentation of the American market in recent years has made it almost impossible for any single product to retain a sizable share-of-the-market. Can you give examples that illustrate or refute this statement?
8. Today, standard sizes are commonly used for canned goods, but there is no standardization of package size for detergents. How would the detergent manufacturers benefit, and how would they lose from standardization of packages?
9. "Special-order business should cover an allocated share of total costs, if it is to be accepted. There is no other long-range justification for accepting such business." Please comment.
10. Can packages be used *effectively* to differentiate products that could not otherwise be differentiated? Give an example.
11. Is there an important relationship between choice of channels of distribution and packaging decisions? Explain.
12. Would it be sensible to establish a rule of thumb that no package is justifiable if it increases the cost of the product by more than ten per cent? Why?
13. It seems pretty clear that the advantages of using a family brand outweigh the advantages of using individual brands on different products. Do you agree?
14. Multiple brands for identical products are often used to implement a highly selective system of distribution. Would it be fair to say that this is a compromise that doesn't really benefit anyone—manufacturer, retailer, or consumer?
15. Trends in marketing today would lead us to expect an increasingly important role for private brands in the future. Why might this be so?

D I S T R I B U T I O N

P O L I C I E S

A N D

P H Y S I C A L

D I S T R I B U T I O N

# 17

In making the complex marketing decisions involved in distribution policy and the management of physical distribution, a decision-maker finds himself faced with a number of problems which cannot be solved independently of each other. Which marketing channel or channels should be used? How many middlemen should there be at each distribution level? How large should the inventory be? How should the inventory be deployed geographically? How many branch warehouses should there be and where should they be located? Should public warehouses or branch warehouses be used? What modes of transportation should be used? The way *any* of these questions

is decided will directly affect the possible ways the others can be decided. These decisions are interlocking ones, and a decision-maker cannot afford to make any of them independently. In this chapter we will consider the conceptual nature of these problems and the main bases for approaching and making decisions on them.

#### DETERMINATION OF MARKETING CHANNELS

What should a marketing executive try to accomplish in his determination of distribution channels? According to one expert, "a particular business should use those channels or combinations of channels which will contribute most to the securing and maintaining, not simply of the greatest attainable sales volume, but of that combination of sales volume and cost which will yield the maximum amount of profit, both in the short run and in the long run."<sup>1</sup> Now, "should use those channels or combinations of channels" implies that there is not always complete freedom of choice. Certainly, an executive can determine those channels he "should use" through rational analysis of both qualitative and quantitative, marketing and non-marketing factors. In many cases, however, circumstances (e.g., an unwillingness of certain middlemen to handle the product or to co-operate in other ways) can cause differences between what the channels *should be* and what they actually *can be*.<sup>2</sup> The extreme case is the one where external influences, such as pressures from existing middlemen or the absence of desired types of middlemen, force a particular channel decision on an executive. Fortunately, such extremes are rare. Executives usually enjoy some discretion in their determination of marketing channels since there are ordinarily several channel alternatives from which to choose.

#### *Determining Potential Channel Alternatives*

Faced with the task of determining potential channel alternatives, a marketing executive is likely to discover an almost infinite number of combinations of different types of middlemen engaged in different lines of trade at different levels of distribution. From this vast number of potential distribution arrangements, he must first screen those which may be appropriate for distribution of the product. His immediate purpose, then, is to identify alternatives that are sufficiently promising to justify further screening for feasibility. This preliminary screening has some quantitative aspects, but qualitative considerations of the product and market predominate.

<sup>1</sup> C. H. Sevin, "Analytical Approach to Channel Policies," in R. M. Clewett (Ed.), *Marketing Channels* (Homewood, Ill.: Richard D. Irwin, 1954), p. 434.

<sup>2</sup> For an illuminating discussion on this point, see: P. McVey, "Are Channels of Distribution What the Textbooks Say?" *Journal of Marketing*, Vol. 24, No. 3 (January 1960), pp. 61-65.

The nature of a product, its unit value, its technical characteristics, its degree of differentiation from competitive products, whether it is perishable, whether it is a staple or non-staple—these and other product characteristics may limit the number of “potential” channel alternatives. Individually or in combination, they may restrict the alternatives to those in a given line of trade, to those containing a certain number of distribution levels, to those where middlemen are equipped to provide technical service and repair, or to those where middlemen have specialized storage facilities (e.g., for frozen foods) or are specialists in some phase of marketing (e.g., fashion merchandising). The crucial product factors, of course, depend on the particular product. Different product factors form the channel screening bases for a line of home workshop power tools and for a line of imported hams.

The other main basis for this initial screening is the market—the final destination of the product: Research can aid the decision-maker by answering the question: Where do ultimate buyers (ultimate consumers or industrial users), expect to, or prefer to, buy the product? Whether the market is concentrated or dispersed, whether ultimate and intermediate buyers expect their immediate suppliers to play aggressive or passive roles in promoting the product—these and other market factors may be used as screening devices for uncovering potential channel alternatives. The relative significance of specific market factors varies with the particular market the manufacturer wants to cultivate. A cigarette manufacturer, for example, has more channel alternatives—and requires more—than does a manufacturer of high-quality men’s hats. Ultimate buyers expect to find cigarettes in more outlets of more types than they do in the case of high-quality men’s hats. Furthermore, a cigarette retailer plays a passive role in promoting the product; a retailer of high-quality men’s hats, in contrast, plays an active, even aggressive, role.

This initial screening, according to product and market factors, should eliminate most of the channel alternatives from further consideration. If effective, this qualitative comparison of channels with regard to significant product and market factors results in sorting out the potential alternatives from the much larger number of possible alternatives. Those remaining are a manageable few deserving more detailed study and analysis.

#### *Ascertaining Feasible Channel Alternatives*

Unlike the initial screening, which was largely qualitative, the second screening emphasizes quantitative comparison. Typically, this screening for feasible channel alternatives requires the gathering of quantitative information to answer such questions as these: Are there enough of the desired types of middlemen in all the market areas the manufacturer

wants to cultivate? Are the desired middlemen "free" to handle the product, or are they "non-available" and committed to competing products? Will the desired middlemen accept or reject the opportunity to take on the product? How much could it cost to reverse middlemen's unwillingness to stock the product?

Whereas the initial screening focused on the product and market, the second focuses on the makeup of the different channels. For example, detailed examinations are made of individual stores that a manufacturer may want to have represent him at the retail level. For each channel under study, a manufacturer should certainly determine the "reach" of individual outlets at each distribution level—can they reach a sufficient number of outlets on the next level, and are they in contact, directly or indirectly, with a large enough number of ultimate buyers? Quite possibly, as Alderson suggests, a manufacturer may be drawn into supporting and encouraging people to go into business as distributors or dealers in order to obtain the desired type of representation in some market areas.<sup>3</sup>

During this screening, some or many potential channel alternatives will be discarded as not feasible. The two-phase "weeding-out" process should result in a small number of remaining alternatives classed as feasible. These are now ready for further evaluation, most of it quantitative.

#### *Comparing Relative Profitability*

The third screening is directed toward determining the relative profitability of the channel alternatives now rated as "feasible." Essentially, this consists of making estimates of the sales volume potential and the costs of channel usage for each channel alternative. Through comparing these estimates, a decision-maker tries to find the channel alternative which shows the greatest promise of contributing the most to maximum long-run profits. Neither maximum sales volume nor minimum cost is significant in itself, but rather the presence of both in optimum combination. Furthermore, since a decision-maker is concerned both with probable long-run and short-term profits, and since the "length" of the long-run varies with the company and the situation (we will consider this more closely later on in this section), the time element must be taken into account.

The reliability of the different comparisons of relative profitability can be no better than the underlying estimates of sales volume potentials and costs of channel usage, and, before a decision-maker can make sound comparisons of relative profitability, he must have certain market statistics. The most basic relate to the potential market. He must have both short-term and long-run estimates of market potential, and from these, perhaps by applying some "target share-of-the-market percentage," he

<sup>3</sup> W. Alderson. *Marketing Behavior and Executive Action* (Homewood, Ill.: Richard D. Irwin, 1957), p. 331.



must derive short-term and long-run estimates of his firm's sales potentials. After considering these sales potentials together with data on the "reach" of outlets at each distribution level, a decision-maker should be able to determine, at least, tentatively, whether a single channel or a number of channels will be needed.

**ESTIMATES OF SALES VOLUME POTENTIAL.** In analyzing each channel for its sales volume potential, decision-makers seek to answer this question: Is this channel capable of reaching a sufficient number of ultimate buyers to assure absorption of the desired quantity of product? The new data needed for an answer to this question are rarely all immediately available. Some may be found in the manufacturer's own records and some may be secured from external sources of market statistics, but some may have to be obtained through special marketing surveys. After adjustments for such factors as the strengths and weaknesses of competitors, and after projecting market trends in relation to the channel being considered, the channel's sales volume potential is determined. Some alternatives may now be eliminated if their sales volume capabilities are clearly inadequate and show little promise of improving. At this point, decision-makers must keep in mind the possibility that there may be no single channel capable of realizing the full sales potential. Two or more may be required and, if this proves to be the case, similar estimates will have to be made for the different channel combinations.

In addition, the attainable level of sales volume, regardless of the channel or combination, is strongly influenced by the ability of marketing management, the excellence of its planning, and its skill in the implementation of sales programs and campaigns. A decision-maker should not necessarily assume that the managerial competence of his subordinates who are charged with translating his decision into action will be the same, regardless of the channel under study. There is no denying that the same subordinates may be able to obtain excellent sales results from some channels and mediocre results from others. The decision-maker must decide where his subordinates are strong and where weak and make his decisions accordingly.

**COSTS OF CHANNEL USAGE.** With estimates of sales volume capabilities on hand, the next step is to determine the costs of moving these volumes through the different channels. Essentially this is a matter of marketing cost analysis, one of determining probable costs of performing required marketing functions under each arrangement. In each channel there is implied some scheme for dividing up performance of marketing functions, of apportioning some to the manufacturer and others to different "channel

members." The costs of performing each marketing function at each distribution level and the total costs of performing the entire marketing task must be estimated for each channel.<sup>4</sup>

In analyzing probable costs of channel usage, decision-makers must consider possible "hidden" costs. In estimating costs of performing the storage function, for example, costs of breakage, spoilage, and pilferage, while usually hidden, must nevertheless be taken into account along with total warehousing charges. Furthermore, in certain industries, manufacturers experience serious problems, financial as well as marketing, caused by apparently erratic inventory fluctuations. If on the one hand, inventory is larger than it has to be relative to the volume of incoming orders, money is tied up in inventory that could be invested or earning interest elsewhere—the hidden cost of being overstocked. If, on the other hand, inventory is too small relative to the volume of incoming orders, many customers cancel their orders and patronize other sources of supply—the hidden cost of being out-of-stock. In one remarkable simulation study (i.e., computer replication of a business situation), it was demonstrated that the use of more than three distribution levels can bring about marked instability in inventory sizes, both for the manufacturer and for the middlemen.<sup>5</sup> One implication was that a manufacturer's use of "long channels" could be the underlying cause of wild fluctuations in his volume of incoming orders. It is interesting to note that in the textile industry, which shows marked inventory instability, there are often four or five distribution levels from yarn manufacturer to ultimate consumer. The conventional system of accounting used by most manufacturers provides no way of recording the hidden but real costs associated with erratic inventory fluctuations. The possibility of this and other types of hidden costs developing if a given channel decision is made, although certainly a difficult result to predict, nevertheless is an important factor to keep in mind.

**TAKING THE TIME ELEMENT INTO ACCOUNT.** In appraising long-run profit prospects, there is a need to "pin down" how long the long-run is. The number of years in the long-run, of course, varies with management's appraisal of the company's outlook. For a going concern whose management expects little growth, the long-run may actually mean no more than a single year. For a company whose management anticipates rapid and continued growth, the long-run may represent five or ten years or even longer. When the long-run has been specifically defined, management, in

<sup>4</sup> For a brief treatment of some pertinent aspects of marketing cost analysis, see: C. H. Sevin, "Mathematical Programming," in D. W. Ewing (Ed.), *Effective Marketing Action* (New York: Harper & Brothers, 1958), pp. 127-138.

<sup>5</sup> J. W. Forrester, "Industrial Dynamics," *Harvard Business Review*, Vol. 36, No. 4 (July-August 1958), p. 47.

effect, has set its "target date." This, however, is likely to change, as management alters its appraisal of future opportunities with the passing of time. In spite of the fact that exact target dates are somewhat elusive, decisions on distribution channels (certainly major marketing decisions) are not easily reversible and must be "lived with" for a considerable time. Thus, in a manner similar to the proverbial marriage contract, channel arrangements should not be "lightly entered into." In taking the time element into account, therefore, the decision-maker should make certain that his estimate of the number of years in the long-run is sufficiently long to permit reversal of the channel decision should that become necessary.

**A SIMPLIFIED EXAMPLE.** In order to better understand the kind of thinking involved in a rational approach to the channel selection problem, let us consider a highly simplified example. The particular analytical process shown is not meant to represent a process appropriate in all channel selection situations, either industrial or consumer. With that preliminary word of caution, then, let us assume that a certain decision-maker, whose firm markets an industrial product, has only two channel alternatives: either (1) to use a company-controlled sales force and deal directly with industrial users, or (2) to use agents who will be paid on a commission basis. Further assume that sales volume capabilities are identical through either channel. (Although adopted here for simplicity, these assumptions do represent a reasonably accurate statement of the channel alternatives available to many companies in industrial marketing.)

This decision-maker is fortunate in that he has a ready-made standard to use in comparing the two alternatives. It is the particular commission rate at which agents can be secured. Knowing this rate, which we will call "P," he can estimate the costs of using agents and compare the result with his estimate of the costs of using a company-controlled sales force. His decision should favor that alternative showing the most promise of meeting the criterion of maximizing net profits over some given period. But before he can apply the profit criterion, the decision-maker needs four additional estimates:

**X:** number of years during which net profit is to be maximized—i.e., the "long-run."

**S:** total sales volume forecast over X years.

**C:** average yearly cost of keeping a salesman in the field including his compensation and all expenses. Thus, C is the average cost per salesman per year.

**N:** number of salesmen needed to produce S sales volume.

Because of the assumption that "S" will be identical under either alternative, the channel comparison can be made entirely on the basis of cost. The two alternatives, then, may be represented symbolically in cost terms.

SP: cost of producing S sales volume forecasted for X years through agents at a P commission rate.

NCX: cost of using N company salesmen at an average yearly cost of C for X years.

Thus, to determine which of the two alternatives will cost more, this decision-maker should apply the decision rule:

$$\frac{SP}{NCX} = 1$$

If  $\frac{SP}{NCX} > 1$ , it will cost more to have agents do the selling; therefore, the company should establish its own sales force

If  $\frac{SP}{NCX} = 1$ , the costs are the same for the two alternatives, and the decision may be based on other considerations

If  $\frac{SP}{NCX} < 1$ , it will cost less to have agents do the selling, therefore, the company should not set up its own sales force

This channel selection model also may be used to compute the maximum number of salesmen the company can afford to put in the field without adding to its distribution costs. For this purpose, the so-called "indifference" version of the model is used. First, both sides of the original equation are multiplied by "N" as follows:

$$\frac{N}{1} \cdot \frac{SP}{NCX} = 1 \cdot \frac{N}{1}$$

Cancelling out, the result is:

$$\frac{SP}{CX} = N_{\max}$$

" $N_{\max}$ " is the maximum number of salesmen the manufacturer can afford without having distribution costs exceed those he would incur by using agents.

An important, though unstated, assumption underlying this particular model is that personal selling effort is the predominant element in the manufacturer's marketing mix. This holds for some industrial marketing situations, but not for many consumer goods marketing situations.

*Obtaining Channel Usage*

Obtaining channel usage requires that approaches be made to individual members of the prospective channel team. The manufacturer's proposal must be "sold" to the managements of channel members and, once this is done, there also is need in most cases to follow through and "sell" the team members' sales staffs. In other words, for each channel member organization, someone must convince both the executives and those who do the actual selling.

The decision each prospective channel member must make—either to accept or to reject the manufacturer's proposal—is for him a product-selection decision and such decisions have to be made at each distribution level. To put it another way—while the manufacturer thinks of the situation in terms of putting together a distribution channel, each middleman (i.e., prospective channel member) thinks of it in terms of "should I add or not add this product to my stock." If a consumer product, for instance, is to be marketed through wholesalers and retailers, such decisions would be made at three levels—wholesale, retail, and consumer. Before the consumer can decide to accept or reject the product, the retailer must have already decided to accept it; and before the retailer can make his decision, the wholesaler must have made his decision to accept it.

**COSTS OF OBTAINING CHANNEL USAGE.** In obtaining initial usage of a distribution channel (i.e., in implementing the desired channel decision), the manufacturer necessarily incurs certain costs. The nature and amount of these costs varies with the skill of marketing management in implementing a particular channel decision and with its adeptness in putting distribution and promotion plans into effect. Precise estimates of such costs can be made by the decision-maker only when he has reliable appraisals of the effectiveness of those executives who are to be given responsibility for implementing the specific channel decision. Since such appraisals are more likely to be subjective rather than objective, and as they vary with those who make them, this aspect of estimating the initial costs of channel usage is not pursued further here.

Although not strictly according to conventional accounting practices, the marketing executive should view the costs of obtaining *initial* channel usage as an investment (accountants normally classify such costs, e.g., costs of product introductory campaigns, as expenses). This investment, made to implement a long-run decision, can only be expected to "pay off" over several years; thus, at least in his planning leading up to the decision, the executive should think in terms of amortizing (writing off) this investment over the long-run period. After all, as has been repeatedly emphasized throughout this book, the executive making major marketing decisions should be trying to maximize long-run rather than short-term profits.

It should be mentioned, however, that once channel usage is secured, both marketers and accountants agree that the costs of *continued* channel usage should be treated as short-term operating expenses rather than as a long-run investment.

**MIDDLEMEN'S PRODUCT-SELECTION DECISION PROCEDURE.** In preparing their approach to prospective channel members, marketing executives are well-advised to study the way most middlemen make product-selection decisions. With certain exceptions found mainly among the largest retailers and wholesalers, most middlemen simply do not have sufficient sales and cost data to make rational product-selection decisions. The typical middleman handles a large number of different products, and his records rarely indicate sales by individual products. This same variety in the inventory makes it almost impossible to assign costs to specific items. Furthermore, such sales and cost statistics as he does have may be difficult to project for future operating periods. Considering these circumstances, then, it is hardly surprising that middlemen generally base product-selection decisions on non-rational grounds.

Among retailers, for example, it is common to appraise relative profitability among brands according to relative percentage markup. A retailer will probably prefer a brand carrying a 20 per cent markup to one with a 15 per cent markup. The implicit assumption is that the two brands will not differ as to rate of inventory turnover and sale, price, or handling costs. Although a retailer may not be totally unaware of differences among brands in these respects, he tends to assign a heavier weight to relative markup percentages because he has more information about them.

In referring to the way retailers *should* make product-selection decisions, one author says:

Gross profit per square foot of display space is probably the most useful criterion that can be found. Although the incremental net profit rather than the average gross profit is correct conceptually, average gross profit is easier to compute and it is usually a satisfactory approximation. The average gross profit per square foot is computed as follows:

$$\frac{\text{MARKUP (in dollars and cents)} \times \text{RATE OF SALE}}{\text{NUMBER OF SQUARE FEET OF DISPLAY SPACE}}$$

The method involves certain significant assumptions:

1. It assumes that all display space is equally effective in selling products. Such an assumption does not hold in many instances—there are “hot spots” in a store. The manager with experience acquires a judgment as to their location; thus, most of the choices that he makes concerning the use of the space relate to different brands of a product, and the choices do not require a comparison of widely different areas in the store.

2. It assumes that incremental costs vary directly with the volume of sales of each brand. Viewed practically, this method avoids the cost-allocation problem. . . . However . . . the only major cost varying with volume, is cost of goods sold. This cost varies directly with volume, except in extreme cases where quantity discounts by the manufacturer would cause a decreasing unit cost.
3. It assumes that all display space is fully utilized. If this is not true in a given situation, the amount of space used should not be a consideration. In practice, however, all display space is usually fully utilized <sup>6</sup>

In building and managing inventory, therefore, a middleman should attempt—rationally—to equalize the marginal gross profit contribution in dollars for each square foot of selling space. Many retailers do attempt to do this, although intuitively, by allotting “slow sellers” less shelf space than “fast sellers”—typically, slow sellers have higher markups than fast sellers—and by putting best sellers in the best selling spaces. Thus, even though middlemen commonly attach too much significance to relative percentage markups, their total pattern of behavior in making product-selection decisions is not quite so irrational as it first appears. Marketing management should anticipate this sort of “semi-rational” behavior in planning its approach to prospective channel members. Later on, i.e., once distribution is obtained, marketing management may derive additional benefits if it has information on middlemen’s procedures in buying and stocking. Philip Morris, Inc., for instance, found that certain of its competitors were “renting” space on cigarette display racks for their own brands in self-service retail stores. In many stores this practice resulted in some of Philip Morris’ brands being frequently out-of-stock on display racks—even though back room “reserve” stocks of these same brands were fully adequate. To combat this competitive tactic, Philip Morris undertook to “educate” retailers on the wisdom of apportioning display space to individual brands in proportion to their respective rates of sale. From the results of field investigations, Philip Morris was able to prove to retailers that apportioning space to brands according to rates of sale would almost invariably increase the total profit contribution. Armed with these research results, company salesmen succeeded in obtaining a fairer allotment of display space for Philip Morris’ various brands.

#### **DISTRIBUTION INTENSITY**

A manufacturer must also decide how many middlemen he should seek on each level of distribution. Depending on the desired channel arrangement, he must, in the case of a consumer product, for example, determine the number of retailers, the number of wholesalers, the number of agents, and

so on. Similarly, related decisions have to be made within the company organization concerning the number of salesmen needed, the number of district sales managers, and so on. Notice that the problem of determining the numbers of middlemen blends naturally into one of deciding the structure and type of the manufacturer's sales organization.

Decisions on the number of middlemen may be thought of as decisions on the degree of distribution intensity. There are three general degrees of distribution intensity: mass, selective, and exclusive. This is an arbitrary classification, for there are many intermediate gradations. Distribution intensity should be thought of as a broad band with mass distribution at one end and exclusive distribution at the other. Within this broad band there is a very large number of points representing different shades of selective distribution.

**EXTREMES OF DISTRIBUTION INTENSITY.** The two extremes, as stated above, are mass distribution and exclusive distribution. Mass distribution provides maximum sales exposure for a product, whereas exclusive distribution involves using a single middleman, a retailer, for example, in each market area. Normally, a manufacturer must use multiple channels, and frequently some very long channels among them, to achieve mass distribution intensity. In contrast, a manufacturer using exclusive distribution tends not only to have a single channel, but to sell directly to the chosen outlets.

**SELECTIVE DISTRIBUTION.** Most manufacturers have neither complete mass distribution nor complete exclusive distribution but rather some form of selective distribution. Voluntarily or involuntarily, in pursuing a policy of selective distribution, manufacturers restrict the number of outlets on each distribution level. Voluntary restriction occurs when a manufacturer decides in a given market area, for instance, not to use every conceivable outlet for his product but to use only a few of the more desirable outlets. Involuntary restriction occurs either when certain "desired" outlets refuse to handle a manufacturer's product or when the number of available outlets in a given market area is less than the number the manufacturer would like to have in that area. Sometimes, the number of middlemen is limited to only those that can best serve the manufacturer (i.e., be the most profitable), but the more modern view is that the number of outlets should be limited to those that can best serve sufficiently large numbers of ultimate buyers (i.e., not necessarily including *only* those outlets most profitable to the manufacturer but also other outlets, such as those situated in locations more convenient to ultimate buyers). If skillfully implemented, selective distribution usually results in greater profits for each channel member. The manufacturer gains because he sells to a smaller



number of accounts (thus reducing selling expenses) and at the same time he should sell more to each account. The middlemen gain because fewer of their competitors handle the manufacturer's product, permitting the middlemen to attract trade that might otherwise go elsewhere. Better merchandising practices also are likely to augment the profits of manufacturer and middlemen alike: there will be fewer "out-of-stocks" because more adequate inventories are handled; more valuable retail display space tends to be used; at all levels there is more desire to cooperate in coordinating promotional efforts. Even the manufacturer's "small order" problem may disappear almost entirely.

**DECISIONS ON DISTRIBUTION INTENSITY.** Much of the information that is assembled and analyzed for making decisions on distribution channels is also pertinent to decisions on distribution intensity. Indeed, both these decisions should be made together. Particularly important, however, in deciding on distribution intensity are a product's marketing characteristics. The more frequently end-buyers purchase a product, the stronger the argument for mass distribution or for an extensive form of selective distribution. The greater the gross margin is for the middlemen, the more persuasive the argument for something closer to exclusive distribution. The amount of product service expected by end-buyers may vary from none at all (a point in favor of mass distribution) to a large amount (an argument for exclusive distribution). If the useful life of a product is very long, distribution should usually be quite selective or even exclusive. Similarly, the more searching time end-buyers are willing to devote to finding a product outlet, the fewer outlets a manufacturer can afford to have.

The anticipated or actual market position of a brand also influences the decision on distribution intensity. If a brand enjoys only brand recognition, the manufacturer, desiring maximum sales exposure, probably will use mass distribution or something fairly close to it. If a brand has consumer preference, the manufacturer can afford to use some selective distribution. If a brand is so fortunate that end-buyers insist on it and refuse substitutes, highly selective distribution is feasible and exclusive distribution may be possible. But few brands are "insisted upon" or even "preferred" by all consumers, and each market segment is likely to regard the brand somewhat differently. Thus, the distribution intensity decision must partially depend on the manufacturer's appraisal of how his product stands with different market segments, and his evaluation of the sales potential of each segment.

Many other factors, too many to analyze in detail here, affect the decision on distribution intensity. But it is worthwhile to mention briefly certain additional factors bearing directly on this decision. A manufacturer must take into account the strength of his desire to control price at

each distribution level, and its relation to the size of the "policing" problem. He must appraise the amount of market risk involved in each alternative—for example, exclusive distribution is like "putting all the marketing eggs in a limited number of baskets." He must know the attitudes of distributive outlets—some actively seek and enthusiastically support "exclusives," but others want no "exclusives" or accept them chiefly to deprive competitors of it. Only if he carefully considers and evaluates such attitudes can a manufacturer realistically appraise the relative merits of different policies as to distribution intensity. Nor should he overlook the fact that once he grants "exclusives," it is rather awkward to replace those distributors who fail to measure up to expectations.<sup>7</sup> Replacement of ineffective distributors is awkward to handle not only because of the delicate problems involved in cancelling established relationships but also because potential replacements, knowing of a local competitor's failure with the manufacturer's product, are likely to be skeptical of their own chances for success with it. He must also compare the alternatives in relation to his advertising program—both with respect to the probable amount of waste circulation (i.e., appearance of his advertisements in geographic areas other than those where he contemplates having distributors) and with regard to the problems involved in coordinating middlemen's promotional efforts with his own. Management's attitudes toward competition must also be considered. Someone has to decide whether it is more desirable to have competition inside retail outlets or not and the amount of protection which should be sought from in-store competition and in-market competition.

#### MANAGEMENT OF PHYSICAL DISTRIBUTION

Physical distribution policies and practices are directly related to other distribution policies and practices. Consider what takes place as products move through distribution channels, over time and through space, from points of production to points of consumption. Inventories are held not only by manufacturers but, in most cases, by middlemen at each distribution level and by ultimate buyers at the end of the channel. In the distribution of consumer goods, for example, consumers add to their stocks by buying from retailers. This reduces retailers' inventories and eventually they place replenishing orders with wholesalers. Wholesalers, in turn, replenish their stocks by placing orders with manufacturers. Thus, while products are flowing forward to the final buyers, there is a reverse flow of orders which causes alternating subtractions from and additions to in-

<sup>7</sup> However, some manufacturers faced with handling distributors not measuring up to expectations have found ingenious methods for improving the situation. For instance, see the David D. Doniger & Company case in: R. R. Still and E. W. Cundiff, *Sales Management: Decisions, Policies, and Cases* (Englewood Cliffs, N.J.: Prentice-Hall, 1958), pp. 688-700.

inventories held at each level. Each time a manufacturer ships an order, he initiates this chain reaction in the performance of transportation and storage functions. The details and manner of performing these two functions at each distribution level may vary considerably. Often, different sizes of inventories characterize different distribution levels, and there are wide variations among individual middlemen on the same level. When a channel includes certain types of agents, there may be no inventories at all on some levels. Similarly, middlemen exhibit marked differences with respect to order quantities and frequency of placing orders. The forward flow of goods and the reverse flow of orders both encounter interruptions of varying and quite often unpredictable durations. Either flow (and sometimes both) may fall to "just a trickle" or rise to "flood-stage proportions." A manufacturer may centralize warehousing and shipping activities at one or a few locations, or he may decentralize them through branch warehouse operations or the use of public warehouses. Middlemen, especially those operating multiple establishments, have similar options. Furthermore, in moving goods from one distribution point to the next, different decisions may be made concerning transportation methods. All of these factors, present to some extent in any distribution system, make managing physical distribution an extremely challenging task.

Viewed from the channel position of the manufacturer, physical distribution management requires logistical planning (i.e., integrated planning of all transportation, storage, and supply requirements) and implementation of inventory policy. Decisions must be made concerning the deployment of certain sizes of inventory at specific places and times. In other words, the problem is that of having the right products in the right quantities at the right place at the right times. Within the framework of marketing management, the solution should be one that strikes an optimum balance between costs incurred for physical distribution activities, and expectations of end-buyers and users of the product. Managing physical distribution, then, may be thought of as a balancing of distribution costs against an acceptable level of customer satisfaction.

#### *Manufacturer's "Control" Over Physical Distribution*

Because manufacturers generally reach final buyers through intermediate levels of distribution, they find that they cannot completely "control" (i.e., direct and regulate) the physical distribution of their products. This is because they are bound to find distribution levels and points where they have little, if any, control over the size and disposition of inventories. However, at least in theory, a manufacturer does direct and regulate inventories at the factory and at his own distribution points (warehouses). For these points directly under his control, physical distribution decisions can be "optimal." But they are optimal only in the sense that they are the

best under the circumstances—considering such factors as costs, the characteristics of demand, and the inventory eccentricities of distribution points further down the channel.

A manufacturer must normally try to obtain optimum performance of the total distribution system by finding effective ways of coordinating his inventory policies and practices with those of other channel members. What middlemen do (or do not do) with regard to managing their inventories definitely affects the manufacturer's costs and profits. Their actions also determine the quality of service and availability of the product at the times and places desired by final buyers. If middlemen are overstocked, they are likely to cut prices in order to make sales, thus jeopardizing future sales at more normal prices, possibly damaging the manufacturer's reputation for quality products, and perhaps making themselves less enthusiastic about future relationships with the manufacturer. If middlemen follow unintelligent inventory practices, such as buying on a "hand-to-mouth" basis, the manufacturer is forced to carry larger inventories and, consequently, to incur higher costs. Furthermore, he, along with the middlemen, suffers hidden costs as penalties for being out-of-stock and unable to fill orders when consumers want them. Unfortunately, out-of-stock costs are not recorded by conventional accounting systems, but profits as well as sales are lost when consumers are sent away empty-handed.

#### *Physical Distribution Efficiency and Profit*

Gains in physical distribution efficiency should be accompanied by improvements in net profit. Estimates of physical distribution costs have shown that they account for as much as one-third of the manufacturer's selling price and from one-fifth to one-fourth of the price paid by the consumer.<sup>8</sup> Marketing management is profit-oriented management; hence, any functions accounting for so much of total costs should be prime targets for management's efforts to secure more efficient performance. If, after consideration of market demand, physical distribution costs seem higher than they have to be, there are ways to reduce them and thereby improve profits.

**THE NABISCO EXPERIENCE.** The experience of the National Biscuit Company in reorganizing distribution is a good case in point.<sup>9</sup> Nabisco's policy is to provide frequent and direct distribution to retail outlets. Nearly 3,500 salesmen make one or more calls each week on approximately 350,000 customers. Salesmen service these outlets and take orders, which

are delivered within 48 hours by Nabisco's fleet of 1,500 trucks. For many years, Nabisco's line of cereals and dog foods received the same high-priority and high-expense treatment as the perishable cookies and crackers, although nearly all competing manufacturers of dog food and cereals reached most retailers through wholesale grocers.

Nabisco management set up a task force to study methods for improving distribution efficiency. The task force analyzed sales volume, cost and profit figures on the cereal and dog food products to determine the costs at each stage in the distribution system. Field salesmen conducted a survey of the cereal and dog food buying practices of independent grocers. Branch managers and special representatives studied the buying habits and service requirements of leading chain and wholesale outlets. The data collected were considered in relation to other company information on sales volume, type of account, class of market, geographic area, and the like.

Working with these data, Nabisco's traffic department developed a delivery pattern that was geared to wholesale selling and estimated costs required to meet normal service requirements of all outlets. A special-products division was set up in 1954 and charged with responsibility for handling the cereals and dog foods. Since that time, according to Nabisco management, this division has been operating smoothly, providing lower-cost, higher-profit distribution for the cereal and dog foods.

#### *Decisions on Size of Inventory*

Inventories may be thought of as input-output systems, with inventory additions being the input and inventory subtractions the output. Or, they may be thought of as reservoirs of goods that are held in anticipation of making sales—i.e., of filling demands from farther down along the channel. At usually irregular intervals, incoming quantities of the product ready for sale arrive and are added to the inventory reservoir. The outgoing product flow is more continuous, but outgoing quantities fluctuate considerably. The volume in the inventory reservoir is always pulsating but not always with a regular rhythm—from day to day, changes occur in the rates and quantities of input and output. Therefore, in deciding on inventory size, management must determine both how high the inventory should be allowed to rise and how low it should be allowed to fall. In setting the upper and lower control limits, there are both sales and cost considerations.

**SALES CONSIDERATIONS.** The main purpose in maintaining any inventory at all is to be prepared to meet market demands—i.e., to make sales and to fill customers' orders. Since inventories are kept in *anticipation* of market demand, the upper and lower control limits should be attuned to

forecasted sales. Sound decisions on inventory size, therefore, depend upon accuracy in sales forecasting. The more accurate the sales forecast, the greater the opportunity for maximizing gains from economical inventory operations. The less accurate the sales forecast, the greater the need for building substantial buffer stocks into the inventory plan, over and above normally adequate reserve stocks. It is, of course, impossible to determine in advance the exact degree of accuracy in a sales forecast. But it *should* be possible to obtain probability forecasts or, at the very least, some estimate of the forecasting error or limits to error.<sup>10</sup> With both a sales forecast and some fairly definite notion as to its probable accuracy, a decision-maker is much better prepared to set the control limits.

There are two additional factors which must be taken into account. One relates to what management considers an acceptable level of customer service. Experience shows that, in a typical business, about 80 per cent more inventory is needed to fill 95 per cent of the customers' orders out of stock on-hand than to fill just 80 per cent.<sup>11</sup> Settling on some goal, then, as to the proportion of all customers' orders which the stock-on-hand should be capable of satisfying without delay, has a definite bearing on the upper inventory control limit. The other factor relates to responsiveness of the distribution system—the ability of a system to transmit needs back to the supplying plant and get needed material into the field. The amount of responsiveness determines how quickly the inventory can be adjusted to changes in demand.<sup>12</sup> Thus, distribution system responsiveness directly influences the lower inventory control limit.

Sales output, the most important component of any inventory system, generally cannot be controlled directly because it depends on decisions made by people outside the organization. However, even though a decision-maker cannot directly control sales output, he still must take its characteristics into account in making inventory decisions.

**COST CONSIDERATIONS.** The input component of the inventory system generally is controllable by decision-makers within the organization. It needs reiterating, though, that in spite of the close interrelations of input and output, input is more of the nature of a dependent variable and output more like an independent variable. Therefore, although control over inventory level and input normally takes the form of cost control, all inventory costs are ultimately largely traceable to inventory output factors.

Three main groups of costs are associated with the inventory. The first,

<sup>10</sup> On this and related matters, see: J. F. Magee, "Guides to Inventory Policy III. Anticipating Future Needs," *Harvard Business Review*, Vol. 34, No. 3 (May-June 1956), pp. 57-70.

<sup>11</sup> J. F. Magee, "The Logistics of Distribution," *Harvard Business Review*, Vol. 38, No. 4 (July-August 1960), p. 92.

<sup>12</sup> *Ibid.*

holding costs, includes warehousing and storage charges, cost of capital tied up in inventory, costs of adverse price movements, obsolescence, spoilage, pilferage, and taxes and insurance on inventory. The second, costs of shortages (i.e., of having negative inventories), includes special clerical, administrative, and handling expenses, and, most importantly, losses of specific sales, of good will, and even of some customers. The third group, costs of replenishing inventory, differ in composition depending upon whether a business does its own manufacturing or not. Inventory replenishing costs in a "make and sell" business are mainly manufacturing costs—labor and machine setup costs, costs of material used during setup testing, cost of time during which production cannot take place because of setups, clerical and administrative costs, and the like.<sup>13</sup> Inventory replenishing costs in the "sell" type of business are those for clerical and administrative work, for transportation and unloading, for placement in warehouses or stores, and for performing related necessary activities.

**COST BALANCING AND INVENTORY DECISION.** Inventory decisions can be formulated in terms of balancing inventory costs. Whereas holding costs rise as inventory increases, both the costs of shortage and of inventory replenishment decrease as inventory increases. Holding, shortage, and replenishment costs are all related, then, to the size of the inventory; total costs are, therefore, a function of the amount stored, and the decision problem is to determine what amount to store in order to minimize these costs.<sup>14</sup> Stating the problem in another way, a decision-maker wants to decide (1) how many (or much) to order (i.e., produce or purchase), and (2) when to order.<sup>15</sup> Essentially, these decisions involve balancing inventory holding costs against either costs of shortage or costs of replenishment or both. One of the earliest and most significant contributions made by operations research was the construction of models (theories expressed as mathematical formulas) designed to minimize total inventory costs under different sets of conditions.<sup>16</sup> Operations research has furnished the analytical tools, then, which make rational inventory decisions possible. In the past—and too often even now—such decisions were made intuitively, both by manufacturers and by middlemen, chiefly because of the unavailability of pertinent cost data, the failure to recognize its usefulness where it was

<sup>13</sup> E. Naddor, "Elements of Inventory Systems," in C. D. Flagle, W. H. Huggins, and R. H. Roy (Eds.), *Operations Research and Systems Engineering* (Baltimore: The Johns Hopkins Press, 1960), pp. 333-4.

<sup>14</sup> D. W. Miller and M. K. Starr, *Executive Decisions and Operations Research* (Englewood Cliffs, N. J.: Prentice-Hall, 1960), p. 390.

<sup>15</sup> C. W. Churchmen, R. L. Ackoff, and E. L. Arnoff, *Introduction to Operations Research* (New York: John Wiley & Sons, 1957), p. 15.

<sup>16</sup> Most basic books on operations research treat inventory models in considerable detail. For an excellent and unusually clear treatment, see: E. Naddor, *op. cit.*, pp. 311-364.

available, or its suppression to conceal executive incompetence in inventory management.<sup>17</sup>

### *Decisions on Inventory Location and Transportation*

Decisions on inventory locations and the methods to be used in transporting shipments from one stocking point to the next are closely linked to decisions on inventory size. Physical distribution costs are incurred as a result of all three decisions, and each should be made only after considering implications for the other two. For instance, a decision on where inventories are to be geographically located restricts the range of alternative decisions possible with regard to both the total size of the inventory and methods for transporting it to stocking points. Inventory location and transportation decisions, as is true of decisions on inventory size, should be made with both costs and the market in mind. Once again, then, the conceptual nature of physical distribution management is apparent—effective management seeks to balance costs against an acceptable level of customer satisfaction. The objective should be to obtain the lowest possible total cost of physical distribution while maintaining customer service at a level management considers satisfactory. It is not desirable to separately minimize the costs of inventory size, inventory location, and transportation—the aim should be to minimize their total. Often this may mean that transportation costs, for example, will have to be increased in order to achieve more-than-offsetting cost savings in smaller inventories situated at fewer locations.

**GEOGRAPHIC DEPLOYMENT OF INVENTORY.** There are three possible decisions with regard to geographic deployment of inventory: (1) concentration at or near the plant or at some other central location, (2) dispersion at several distribution points situated in or closer to the main markets, and (3) concentration of substantial inventories at a few distribution centers and redistribution to a larger number of distribution points dispersed throughout the market. The first two decisions are opposite extremes; the third is a compromise solution. The best decision for any particular manufacturer or middleman, depends, of course, on many factors. The principal factors affecting this decision are covered in the following discussion.

A comparison of inventory concentration and dispersion reveals oppo-

<sup>17</sup> For a highly interesting discussion of the inadequacies of usual accounting records and an illustration of their resultant effect on inventory management, see: H. Anshen, "Price Tags for Business Policies," *Harvard Business Review*, Vol. 38, No. 1 (January-February 1960), p. 73.

On the difficulty of assessing different kinds of executive mistakes in inventory management, see the stimulating article by C. A. Bliss, "Are Inventories Really Too High?" *Harvard Business Review*, Vol. 38, No. 5 (September-October 1960), pp. 59, 60.



site sets of strengths and weaknesses. The company that concentrates its inventory can get by with a smaller total inventory and can minimize orders not filled because of stock-outs, but at the costs of higher charges for transportation and possible delays in customer service. The firm that disperses its inventory needs a larger total inventory to avoid an undue number of stock-outs and, in effect, commits each sub-inventory to sale in a particular market area; but it gains reduced total transportation charges and faster customer service. The concentration decision permits more rapid adjustment to changes in the makeup of incoming orders since unexpected demands originating from certain, but not all, markets usually can be met at once. In contrast, the dispersion decision requires either that a large enough reserve stock be maintained at each branch to meet most emergencies, or that there be some provision for moving stocks among branches as needs arise. Thus, the dispersion decision requires the greater inventory investment since the sum of many small reserve stocks scattered over the whole market necessarily is larger than one large reserve stock held at a single location. Similarly, operating one large central warehouse should mean greater warehousing efficiency at lower costs per unit of product handled than can be achieved through the decentralized operation of smaller storage facilities. On the other hand, especially if the product line is made up of mostly bulky and low unit value items—the kind which usually must be shipped by truck or rail—total transportation costs may be lower when decentralized warehouses are used. This is because rail and truck freight charges normally are lower for full carloads or truckloads than for shipments in less-than-carload (l.c.l.) lots. Both decisions, then, have general strengths and weaknesses, and whether a marketer chooses one or the other—or adopts the third as a compromise—depends upon his evaluations of the relative importance of each factor. These specific evaluations, in turn, are influenced by such matters as the nature of the product line, the type of distribution channel, pricing policies, and the practices of the competitors.

**INVENTORY DISPERSION AND WAREHOUSE OWNERSHIP.** Manufacturers deciding to disperse their inventories (as under decisions two or three above) have the choice of either operating their own branch warehouses or of using public warehouses. For any manufacturer, this choice depends upon such factors as the amount of sales volume originating in particular markets, whether he prefers fixed or variable warehousing costs, the degree of flexibility desired in making changes in the pattern of inventory deployment, relative warehousing efficiency, and the distribution channel used. There is relationship and interaction among these factors so it is rare that a manufacturer will base his decision on any single factor. If the volume of goods moved in a given market is substantial and shows

little or no seasonal fluctuation, a good case can be made for branch warehouses owned and operated by the manufacturer. This is because the costs of branch warehousing are mainly fixed and, with a large and steady "flow-through" of goods, the costs per unit of product moved are likely to be quite low. However, because public warehouses base their charges on the space and labor actually used, the scales generally tip in their favor only when a small volume is to be handled or when a large volume with great seasonal fluctuations is to be moved. The variable costs associated with the use of public warehouses also provide a manufacturer with greater flexibility in making changes in the geographical deployment of his inventory. Since most cities have many public warehouses, he can easily close out stocks in some locations and place them in others.

The chief economic justification for the public warehouse is that it provides a way for dovetailing the local storage needs of many manufacturers which, in turn, makes possible efficient use of storage space, warehousing labor, and mechanized handling equipment. However, with a large and steady sales volume of his own, a manufacturer may realize comparable efficiencies in operating his own branch warehouses. Furthermore, if he has a product requiring either specialized handling and technical service or special storage facilities, he has little choice but to own and operate branch warehouses. Although a few cities do have public warehouses that provide specialized handling and technical services (e.g., those specializing in appliance warehousing) and warehouses that offer specialized storage facilities (e.g., those with refrigerated storage space) such specialized public warehouses cannot be found in all cities. So the manufacturer who uses them in some cities may still have to operate his own facilities elsewhere.

Some manufacturers use public warehouses as substitutes for wholesalers, for local sales representatives, or for both. Those manufacturers place "spot stocks" in public warehouses and furnish the operators with "accredited lists" of customers authorized to receive deliveries of various sizes of orders. The public warehouseman not only fills these orders, but often attends to such details as billing and making collections. Generally, public warehouses are not very aggressive sales representatives, so the manufacturer using them for that purpose usually has to rely on such devices as exclusive retail outlets or heavy consumer advertising to "move the goods out of the warehouses." Still another reason for using public warehouses lies in the fact that they issue warehouse receipts which a manufacturer may use as collateral for bank loans; however, unless the goods are in storage for a long period, this is only a source of short-term loans during which time the goods may not be sold. We have pointed out, then, public warehousing and private warehousing both have

their own advantages and disadvantages. Therefore, before making his decision, a manufacturer is well-advised to consider all the merits and limitations of both systems.

**NUMBER AND LOCATION OF WAREHOUSES.** One of the more baffling problems confronting a manufacturer who has decided on inventory dispersion is that of determining the number and location of warehouses. Such a decision is affected by several important variables including customers' buying patterns and delivery expectations, freight rate structures, service characteristics of alternative transportation media, warehouse operating costs, location of factories, production capacities and product mix of individual factories, and costs of building or renting suitable warehouses in different cities. It is possible to gather statistics and related information on each of these variables but there is a staggering number of possible combinations which may be made of so many sets of complex, and to some extent interrelated, variables. Thus, in the past, largely because of the mountain of work involved in calculating the probable results of each possible combination of variables, most decisions on number and location of warehouses were made intuitively. With the advent of the high-speed digital computer, such computations have become more routine.

Operations researchers have devised "simulation" techniques which permit mathematical representations of a company's distribution system, present and proposed, to be programed on a computer. In a comparatively short time, a computer can provide the probable results of operating under a number of different possible schemes as to number and location of warehouses. Such simulation studies often furnish decision-makers with much additional information needed in making decisions on related problems. This is indicated in the following quotation:

For the H. J. Heinz Company, the simulation has provided a unique tool for determining the number of warehouses and mixing points which should exist in the national distribution system. It also has determined where they should be located to achieve a minimal over-all operating cost. In addition, it has provided information on how best to service the many thousands of customers by an optimal combination of service direct from factory and service from area warehouses. Further, it has given a detailed plan for allocating customers for each product line and from each factory. With this cohesive national distribution plan in hand, management has now proceeded to make future marketing plans with assurance of lowest actual distribution costs.<sup>18</sup>

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<sup>18</sup> H. N. Shycon and R. B. Maffei, "Simulation—Tool for Better Distribution," *Harvard Business Review*, Vol. 38, No. 6 (November-December 1960), p. 66.

**APPLICATION OF LINEAR PROGRAMING.** The "transportation technique" of linear programing is used in planning shipments from different origins to different destinations in ways that minimize total shipping costs. For example, the origins may be factories or other sources of supply, distribution centers, or warehouses; the destinations may be distribution centers, warehouses, customers, or stores. Thus, with customer demand for the product at various locations, and supplies at a number of warehouses, it is possible through linear programing to determine which warehouse should ship how much product to which customer in order to minimize total shipping costs. Until the development of the transportation technique of linear programing, no simple procedure more scientific than the "cut and try" method was available for solving problems of this sort.<sup>19</sup>

A more general method of linear programing, the simplex method, is used in finding solutions to "multi-dimensional distribution problems." The transportation technique is used only with two-dimensional problems, such as those involving shipments between several origins and several destinations. Dimensions above and beyond this may include various time periods, different products, and one or more intermediate storage points in the distribution system.<sup>20</sup> One major oil company uses such a model for planning the optimum means of serving its widely dispersed terminals. This particular model evaluates alternative means of serving terminals (i.e., through use of pipelines, barges, tank cars, and so on) by relating their probable future costs to projected changes in volume and product mix at each terminal.<sup>21</sup> An alert reader will see the similarity between the handling of this problem and the simulation we discussed earlier. In both instances, mathematical formulations were used to describe quantitatively the operation of a real distribution system.

**DECISIONS ON MODES OF TRANSPORTATION.** Thus far, we have said nothing concerning decisions on modes of transportation. Any extended discussion and comparison of different modes of transportation and the many technical aspects of using each (e.g., rate structures, rate determination, and various "privileges" granted shippers by carriers) would be

<sup>19</sup> H. C. Bunke, *Linear Programming: A Primer* (Iowa City: Bureau of Business and Economic Research, College of Business Administration, State University of Iowa, 1960), p. 5. This source contains concise and clear explanations of a number of linear programing techniques.

<sup>20</sup> For an explanation of the application of linear programing techniques to multi-dimensional distribution problems, see: J. W. Metzger, *Elementary Mathematical Programming* (New York: John Wiley & Sons, 1958), pp. 54-58.

<sup>21</sup> W. J. Platt and N. R. Maines, "Pretest Your Long-Range Plans," *Harvard Business Review*, Vol. 37, No. 1 (January-February 1959), p. 120.

clearly beyond the intended scope of this book.<sup>22</sup> We should note, however, that great improvements are being made in transportation services. Truck transportation is improving with the construction of more super-highways, the increase in truck speeds, and the use of trailers with greater capacities. Rail freight transportation is improving as more roads provide "piggyback" (rail movement of loaded tractor trailers) and other service innovations. Air freight transportation is improving with the introduction of jet air carriers and the use of "containerized" (giant containers holding many smaller shipments) loading and unloading systems. These are only a few of the many improvements being made in transportation services, but they are indicative of a strong general trend toward providing shippers with more rapid transportation services.

Too often decisions on modes of transportation are made solely in terms of relative costs. In these cases, management fails to recognize that transportation is only one part of what should be a totally-integrated physical distribution system. When transportation decisions are made on the basis of relative costs alone, shipping costs may be minimized but total physical distribution costs usually are not. Minimum shipping costs arrived at solely on this basis generally mean that transportation cost savings are more than offset by increases in warehousing costs, costlier packing, and the costs associated with carrying inventories which are larger than necessary.

Decisions on modes of transportation, then, should be made with the goal of optimizing the efficiency of the total physical distribution system. Relative costs, although important, provide only one basis for comparing the contribution of different modes of transportation to total system efficiency. Mention was made earlier of the general trend toward providing shippers with more rapid transportation services. Transport time—the time required for moving goods from warehouses, for example, to customers—is a major transportation determinant of efficiency (or inefficiency) in the distribution system. Reductions in transport time, though commonly accompanied by increased transportation costs, often result in significant savings in warehousing costs, packing costs, and funds tied up in inventories. For instance, switching from a distribution system composed of surface transportation and branch warehouses to one involving air transportation direct to the customer normally results in higher transportation costs but much lower storage costs.<sup>23</sup> The net

<sup>22</sup> The reader interested in these and related topics is referred to any of the several excellent texts on transportation. Among these are: S. Daggett, *Principles of Inland Transportation*, 4th ed. (New York: Harper & Bros., 1955); D. P. Locklin, *Economics of Transportation*, 4th ed. (Homewood, Ill.: Richard D. Irwin, 1954); and C. A. Taff, *Traffic Management: Principles and Practices*, rev. ed. (Homewood, Ill.: Richard D. Irwin, 1959).

<sup>23</sup> For a good description of the techniques used in comparing costs of physical distribution systems containing different transportation cost and time components, see:

savings resulting from such changes trace largely to reductions in transport time. One writer, dealing with the potentialities of airfreight for marketing, illustrates this relationship as follows:<sup>24</sup>

Suppose that in a company doing an annual business of \$100 million, time in transit is reduced from 14 days to 2. Time between reorders is 14 days, communication and processing time is 4 days, and field stocks average \$12.5 million. In such a situation the reduction in transit time might well lead to a reduction in distribution inventory investment of \$6 million, made up of: (1) a reduction of \$3.3 million in transit, i.e., 12 days' sales; (2) a reduction of \$2.7 million in inventories required to protect customer service resulting from a faster, more flexible distribution system response.

It should be brought out, though, that physical distribution costs can sometimes be reduced through the use of slower and lower-cost modes of transportation. For instance, Westinghouse Electric Corporation switched from air to surface transportation for making deliveries of rush orders. By making improvements in all the distribution steps before shipment, Westinghouse saved so much time it could afford to do without the costlier air service.<sup>25</sup> This emphasizes the general principle that transportation decisions should be based both on cost and transport time considerations and that the relative significance of transportation costs and transport times depends on their combined relationship to the over-all efficiency of the total system of physical distribution.

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G. M. Shutes, "Airfreight From a Marketing Viewpoint," *Journal of Marketing*, Vol. 25, No. 2 (October 1960), pp. 39-43.

<sup>24</sup> Magee, "The Logistics of Distribution," *op. cit.*, p. 93.

<sup>25</sup> M. Mandell, "Boosting Sales with Faster Delivery," *Dun's Review and Modern Industry*, February 1960, p. 45.

## CONCLUSION

Few areas of decision-making in marketing are so complex as those pertaining to distribution policies and the interrelated problems of physical distribution management. In no other area of marketing is it more important to strive for as rational an approach as possible to decision-making. Decisions on distribution policies and physical distribution are major decisions, as difficult to make on rational bases as they are to reverse or change. Both groups of distribution decisions require considerable market information, both qualitative and quantitative. But in using this information, the decision-maker is helped greatly if he is able to conceptualize the nature of each problem accurately. Only if he possesses these conceptual skills will he be able to make rational decisions on distribution policies and physical distribution.

**QUESTIONS AND PROBLEMS**

1. Explain the meaning and significance to marketing of each of the following statements:
  - a. The producer does not always enjoy complete freedom in selecting channels of distribution.
  - b. Manufacturers make channel selection decisions whereas middlemen make product selection decisions.
  - c. A manufacturer should consider the middlemen on his channel team as simply extensions of his own marketing organization.
  - d. Managing physical distribution involves balancing distribution costs against an acceptable level of customer satisfaction.
  - e. Effective usage of marketing channels requires a continuous review and evaluation of the marketing uncontrollables.
  - f. When the price level in an industry is rising, the relative competitive position of the most distant producer in the industry tends to improve.
2. Illustrate how product and market factors might affect the initial screening of channel alternatives for each of the following products:
  - a. Cigarette lighters intended to retail at \$15
  - b. Portable, small-screen, transistorized television sets
  - c. Prefabricated swimming pools for homeowners
  - d. Office furniture
  - e. College textbooks
  - f. Electric shavers for women
  - g. Neckties
3. Why should the initial screening of channel alternatives be largely qualitative and the second screening largely quantitative?
4. Analyze the relationship of sales forecasting and marketing cost analysis to the determination of marketing channels.
5. What are the factors which cause many manufacturers to use multiple channels of distribution?
6. Explain the meaning of the following:
  - a. "hidden" costs of channel usage
  - b. logistical planning
  - c. distribution system responsiveness
  - d. spot stocks and accredited lists

7. How do marketers and accountants differ in the way they view the costs of obtaining initial channel usage? The costs of continued channel usage?
8. To what extent does a manufacturer's use of certain channels of distribution place constraints on his decisions with respect to the addition of new products? On his decisions to drop certain products?
9. Under what conditions would you advise a manufacturer to merge with a middleman handling his products? Under what conditions would such a merger be illegal? (Hint: See Chapter 10.)
10. Outline the steps an importer of foreign automobiles might go through in securing an exclusive dealer in a particular city.
11. A manufacturer of dinnerware is considering setting up a distribution system whereby his own salesmen would call directly on ultimate consumers and sell them "in their homes." If the manufacturer decides to set up this system of direct distribution, he will discontinue selling the line through retail department, jewelry, and specialty stores—nearly 2,000 of which now stock his product line. What factors should be taken into account by this manufacturer in making this decision?
12. A producer of machine tools has been selling industrial users directly through his own force of 20 salaried salesmen. What arguments might be put forth to persuade this manufacturer to discontinue direct selling and to use industrial distributors instead? (Note: Industrial distributors in this field normally receive a 20 per cent discount off the manufacturer's list price.)
13. Manufacturers of consumer goods who use wholesalers to reach retail outlets often also employ salesmen to call on wholesalers' customers. Why? Since, in such cases, the manufacturer's salesmen already call on retailers, why shouldn't the wholesalers be eliminated entirely?
14. Explain and illustrate the relationship of accuracy in sales forecasting to decisions on inventory size.
15. What kinds of costs are associated with the inventory? Explain how inventory costs should be "balanced" in making inventory decisions. How does middlemen's management of inventories affect the manufacturer's costs and profits?
16. Should a manufacturer attempt to minimize the costs of inventory size, inventory location, and transportation separately or collectively? Why?



17. Compare and contrast the following decision alternatives with respect to geographical deployment of inventory:
  - a. concentration at or near the plant or some other central location.
  - b. dispersion at several distribution points situated in or closer to the main markets.
18. Under what conditions should a manufacturer operate his own branch warehouses? Use public warehouses? Explain the relationship of fixed and variable costs to the making of this particular decision.
19. "So much has happened so fast in altering the size and distribution of population, in changing consumers' habits and expectations of service, in shifting the pattern of industrial activity and location, in improving the capabilities of different modes of transportation, etc., that any manufacturer who has not drastically changed his pattern of warehouse locations recently necessarily must be incurring unduly high costs of physical distribution." Agree or disagree? Why? How should a manufacturer go about deciding the number and location of warehouses? How often should he review this decision?

## PRICING

# 18

Prices have important effects on marketing operations. When the prices of products are high, few consumers or users will have enough money to buy and so the market may be greatly reduced. For example, many American families can afford to buy a television set priced at \$300 or less, but very few could afford a set priced at \$2,000. But prices must be high enough to yield an acceptable margin of profit or producers and marketers will be unwilling to make and sell the products. Thus, price has effects both on demand and supply.

Although pricing today is normally the result of decisions by modern business management, there are areas

in the economy where pricing is determined by forces outside the decision maker's control. For example, many farm prices are determined solely by the relationship between the available supply and the market demand, as described in classical economic theory. A lettuce farmer does not decide the price he should charge for his crop. He can only accept or reject the current market price. But in most business situations today, the classical theory of value does not apply for several reasons. Most important is the fact that many producers are able to differentiate their products so that consumers will not readily accept competitive products. Another reason is the complexity of our modern economy which makes it impossible for the average consumer to be really informed about all products and prices. A third factor is the evolution of large producers and users of goods who are big enough individually to affect demand or supply.<sup>1</sup> For these reasons, most modern businessmen must establish policies and make decisions with respect to the prices of their products. These prices are called administered prices.

An administered price is a price which is set by management and held constant for a period of time. We have an administered price when a company maintains a posted price at which it will make sales, and at which buyers may or may not purchase as they wish.<sup>2</sup> Three factors are important in this definition. First, price setting is a conscious administrative action rather than a result of the interplay of supply and demand in the market; second, the administered price is set for a period of time or a number of sales transactions and is not subject to constant change; and third, the price is, at least theoretically, not subject to negotiation. Another element which makes the above definition more complete is that administered pricing occurs in a competitive situation, i.e., where the prices of similar products are close together. Prices resulting from managerial decisions are administered prices, and it is these prices that are of interest to marketers.

#### BASES FOR MAKING PRICING DECISIONS

Management often makes its pricing decisions on the basis of cost alone, but several other factors may also affect prices. Among these are the market, actions of competitors and customs in the trade, legislation, and economic conditions. The impact of each of these varies in different situations. Although a particular factor or combination of factors may have no effect on some pricing decisions, the selection of an optimum price will ordinarily involve consideration of more than one factor. This process

<sup>1</sup> Such a condition is known as *oligopoly* or *oligopsony*. For a detailed description of "oligopoly theory" or monopolistic competition, see: Edward H. Chamberlain, *The Theory of Monopolistic Competition* (Cambridge: Harvard University Press, 1948).

<sup>2</sup> Gardiner C. Means, *Industrial Prices and Their Relative Inflexibility*, Senate Document 13, 74th Congress, 1st Session, 1935.

of selecting the optimum price is referred to as price statesmanship.<sup>3</sup>

Surveys of business practice show that at all levels of distribution, cost is the most commonly used basis for pricing.<sup>4</sup> Decision-makers using this method are concerned with two basic elements—the total allocated costs of producing and distributing the product or service, and a fixed margin of profit accepted as normal in the particular industry. This basis for pricing is popular for two reasons. First, it provides an apparently objective basis for decision, although this objectivity is often more apparent than real, and second, its specific concern with profit margins implies a relationship to the long-term profit goal of business. The seeming objectivity of cost data is deceptive because, although costs are expressed in exact dollar amounts, their computation involves many subjective decisions. Production cost accounting requires an arbitrary allocation of overhead costs to arrive at unit costs, and distribution cost accounting often requires a larger number of assumptions. However, cost is still an important decision factor in pricing because the amount of variable or marginal cost establishes at least an approximate lower price limit. With cost as a basis for pricing, the ultimate aim is some established profit goal. This may be expressed as the desired rate of return on the investment, or as some other figure such as sales.

**PRODUCTION COSTS.** Production costs affect prices and, in turn, are affected by prices. Production cost accounting provides an estimate of the variable unit costs of finished products which, when added to the variable unit distribution cost, provides a minimum price base. At the same time, prices affect production costs because of their effect on demand and sales volume. For any productive facility, there is an optimum level of production that is somewhere near normal capacity of production. Production in smaller quantities raises total unit production costs because overhead must be spread over fewer products. Production in larger quantities also raises total unit production costs because of the need then for increasing total overhead by adding a working shift or by adding to plant capacity. The price that equates demand with the most efficient level of production keeps unit production costs at a minimum.

It is particularly difficult to estimate production costs accurately when joint-cost products are involved. A manufacturer who produces several different products in the same factory, often even on the same machinery, may find it impossible to allocate total costs among these products except on a purely arbitrary basis. The unreliability of the resulting cost

<sup>3</sup> James S. Early, "Factors Which Should Affect Pricing Decisions," *Pricing: The Critical Decision*, AMA Management Report, No. 66, p. 14.

<sup>4</sup> Joel Dean, *Managerial Economics* (Englewood Cliffs, N.J.: Prentice-Hall, 1951), p. 444.

data makes it advisable to price the individual products in terms of "what the traffic will bear," using production costs only to insure that total sales revenue on all products is enough to cover total production costs.

**MARKETING COSTS.** Marketing costs, too, both affect and are affected by prices. They affect prices in that they make up part of the total delivered cost of a product. At the same time, prices can increase or reduce marketing costs by affecting demand. A reduction in price may increase demand, making it possible to reduce selling costs (spending for advertising and personal selling), or, if selling costs are maintained at the same level, sales volume will increase and create a reduction in selling-cost per unit. This increased sales volume may also reduce per-unit physical distribution costs by increasing to a more economical volume the units of product to be transported, stored, and handled.

**CONTRIBUTION TO OVERHEAD.** Marketers often find it necessary to vary their prices among different purchasers. Large volume buyers may demand special price concessions not available to smaller buyers. Sometimes these price differentials may be justified by savings in the cost of serving large accounts, which often require less salesman time, lower credit costs, and lower handling costs. But the demanded price concession often may exceed potential savings, so that total income from the proposed transaction is not enough to cover an allocated share of total costs. The seller may still be willing to accept such an offer because of its expected contribution to overhead. As the current sales volume at normal prices is already great enough to cover total overhead, and the proposed sale at a special price will not increase the overhead, this sale need not bear an allocated share of overhead expense to yield net revenue. As long as the proposed price more than covers the direct, or out-of-pocket, costs of the transaction, the excess over direct cost represents profit. This excess over direct costs is called contribution to overhead because the transaction provides an additional contribution toward the payment of overhead expenses that would not otherwise be available.<sup>6</sup> Under the provisions of the Clayton Act, price concessions of this sort are of doubtful legality (See Chapter 10).

### *The Market*

An understanding of the market for the product aids in the selection of the optimum price. Several market factors may affect the choice of a

<sup>6</sup> The "contribution concept" is treated by: A. J. Bergfield, in "The Importance of Cost in Pricing," *Pricing: The Critical Decision*, AMA Management Report No. 60, pp. 16-23.

price. These include the degree of product differentiation, patterns of consumer or user purchasing, elasticity of demand, and characteristics of the market.

**PRODUCT DIFFERENTIATION.** If a producer can sufficiently differentiate his product in the eyes of consumers, he may be able to attract a group of customers to whom product differences will be more important than price. How far the producer can raise his price above those of competitors depends not only on the magnitude of product difference but on the importance of this difference in the eyes of consumers. In such instances, the loyal customer does not ignore price altogether but he is not likely to be attracted by a competitive product solely because of a small price difference. For example, a prospective new-car buyer with a strong preference for Chevrolet will not be persuaded to buy a Ford or a Plymouth because of a price difference, unless the difference is very great. Price is not unimportant to such a buyer and he may shop around among several Chevrolet dealers to get the best terms; but in selecting the *brand*, product differences are more important than price. The various characteristics that differentiate a particular product may range from fashion and styling to quality and durability, but to the extent that these qualities are important to consumers and industrial users, they reduce the importance of price on the products that possess them.

**PURCHASING PATTERNS OF CONSUMERS AND USERS.** Pricing decisions are also affected by the buying habits of consumers and users. Products purchased frequently can be sold profitably by middlemen at a low markup because of the resulting rapid turnover of inventory. When sales are high in relation to investment in inventory, it is only necessary to make a small margin of profit on each sale to achieve a large profit for the year. For this reason, grocery products can be profitably sold at an 18 per cent markup, whereas hardware needs a 33 per cent markup, and jewelry a 50 per cent markup. The usual number of units of a product purchased also affects pricing decisions. Increases in unit sales can reduce marketing costs and at the same time increase consumption. It often costs very little more to sell six of an article than to sell one, so it is possible to offer a price reduction for quantity purchases. And these larger purchases can also increase total consumption because increased availability of the product often causes the consumer to use more. This is the reasoning that led the bottlers of soft drinks to sell six-packs for the price of five individual bottles.

**ELASTICITY OF DEMAND.** The demand for a product is elastic when it is directly affected by a change in price. A 25 per cent decrease in the price

of fresh strawberries increases the volume of sales and total revenues received by sellers, whereas a 25 per cent increase in their price decreases both sales and revenue. Demand elasticity varies widely among different products. The demand for strawberries is elastic. The demand for coal is relatively inelastic. A small change in the price of strawberries can increase their consumption, but a small change in the price of coal will probably have no effect upon demand. Coal is an essential source of heat and energy, and a change in its price will have little effect upon the demand for energy. However, a large price increase may cause users to seek a source of energy less expensive than coal. When the demand for a product is inelastic, the marketer is reluctant to reduce his price because his income per unit is reduced without any compensating increase in unit sales.

When demand is elastic, the pricing decision by the individual firm is a difficult one. No single firm can hope to take business from competitors through a price reduction, since such a reduction can and probably will be met by the competition. A price change will be profitable to the individual firm only if it affects total demand, so that the increase in the number of units sold by the industry will be enough to compensate each firm for its loss of revenue per unit. And, if there are close substitutes for the product, changes in their prices may cancel out or reduce expected increases in demand. If profits are to be maintained, the unit costs of the additional products sold must decline by more than the price reduction. This is more likely to occur in industries with high ratios of fixed to variable costs, but this relationship is less common than might be expected.<sup>6</sup>

A radical price reduction continuing over a period of years can sometimes open broad new markets. On the demand side, the lower prices may open large untapped sources of demand. On the supply side, the larger volume may make possible the introduction of radical new methods of production that materially reduce costs. One of the best examples of such a decision was the reduction in the price of classical phonograph records from \$2.00 to \$1.00 in 1940 by Columbia Records, resulting in a tenfold increase in demand that more than compensated for the reduction in revenue per record. There are many other less dramatic examples where the price reduction has been a gradual one, but the effect on demand has been the same. During the late 1950's the prices of transistor radios were reduced by more than half, and the total demand for these radios increased enormously.

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<sup>6</sup> For a more detailed discussion of this point and a general discussion of price reductions and elasticity of demand, see: Clare E. Griffin, "When is Price Reduction Profitable?" *Harvard Business Review*, Vol. 38, No. 5 (September-October 1960), pp. 125-132.

**CHARACTERISTICS OF THE MARKET.** A number of market characteristics may affect pricing decisions. The size of the market affects the potential sales volume. A large sales volume allows a producer to make use of the most efficient methods of distribution and promotion and so, correspondingly, to reduce marketing costs. The density of the market, or concentration of product users, also affects marketing costs. Any factor that may change marketing costs affects pricing to the extent that it determines the minimum profitable price.

Another market characteristic affecting pricing decisions is the bargaining power of the buyer. The consumer goods manufacturer may have to offer special low prices to large buyers, such as chain stores, to persuade them to buy and resell his products. Similarly, the industrial goods manufacturer often must make price concessions to large buyers to draw their patronage away from competitors. Price differentials such as these are limited, however, by federal legislation preventing discrimination among like buyers (see Chapter 10).

### *Competition*

Under the system of imperfect (or monopolistic) competition prevalent in American business, each producer can gain a partial control over a segment of the market through product differentiation. This may allow him to set prices slightly higher than those of competitors, but when competitive prices go up or down, he must keep his own prices generally in line or the brand loyalty he has built will not be enough to keep his customers.

The tendency of businessmen to watch competitors' price changes reduces the significance of price as a competitive weapon. Unless a price reduction is expected to increase total demand (as in the case of classical phonograph records cited earlier), it is not to the advantage of the individual firm to reduce prices. Since competitors can be expected to match such price reductions, the firm initiating the reduction will gain no advantage from the action and all competitors will suffer a reduction in profits.<sup>7</sup> On the other hand, competitors are unlikely to follow the lead on price increases unless these increases reflect an industry-wide rise in costs. This stickiness in prices, or reluctance to "rock the boat" results in a policy called nonprice competition. In industries with administered prices management prefers to compete on the basis of prod-

<sup>7</sup> An exception to this is predatory price cutting for the purpose of establishing a monopoly, where, if successful, there is an eventual reduction of the market alternatives at the primary level. When the predatory pricing has reduced competition, prices are increased to the normal level. For a detailed discussion of predatory pricing, see: Morris A. Copeland, "A Social Appraisal of Differential Pricing," *Journal of Marketing*, Vol. 6 (April 1942), pp. 177-184, and Robert C. Brooks, Jr., "Price Cutting and Monopoly Power," *Journal of Marketing*, Vol. 25, No. 5 (July 1961), pp. 44-9.



uct improvement or change, selling and advertising, and service rather than on price. In general, the fewer the firms in an industry, the greater the likelihood that they will compete only on these bases, that is, resort to nonprice competition.

Customs of the trade also affect pricing decisions. In many industries, prices are set according to some concept of a "just price" which is often simply a traditional price. This pricing practice is common in many industries, and it acts as a control both over price rises and reductions.<sup>8</sup> For example, the five cent price for chewing gum and many candy bars has become a traditional one in the mind of the consumer, and he strongly opposes attempts to change it. During the period of sharp price inflation shortly after World War II when the general price level rose by more than fifty per cent in a couple of years, several candy bar manufacturers raised their prices to seven or ten cents to cover rising costs but were forced to return to the customary five cents because of buyer resistance—sales dropped alarmingly. Subsequently, a number of candy manufacturers reduced the size of their candy bars rather than "tamper" further with the customary price.

Producers of revolutionary new products have a wide latitude in setting the initial price of these products, since they enjoy a monopoly until competitors can enter the market. Yet, these producers are more likely to set prices that will yield a "reasonable" profit than to maximize short-term profits. In the long run they are better off to attract the largest possible share of the total market before competitive products can be introduced. The lower profits may also discourage some potential competitors from entering the market.

#### *Legislation*

Pricing decisions may be either restricted or broadened by federal or state laws. (We have described this in detail in Chapter 10.) At the federal level, the Clayton Act, as amended by the Robinson-Patman Act, prohibits a number of pricing practices that discriminate among like purchasers. These include cumulative quantity discounts, noncumulative quantity discounts in excess of actual savings, "dummy" brokerage payments and discriminatory promotional allowances. At the state level in the 31 states that have passed such legislation, pricing decisions are restricted by the Unfair Practices Acts, prohibiting sales below costs (or cost plus some designated markup). Pricing alternatives have been broadened in a majority of the states (46 states at last count) by the enactment of the state Fair Trade Laws, by modifying specific legal prohibitions against price fixing to permit a manufacturer to establish the minimum price at which retailers may sell his product to the con-

<sup>8</sup> Dean, *op. cit.*, p. 460.

sumer. Each of these laws has already been discussed in detail in Chapter 10, but they are mentioned again here because of their possible effects on pricing decisions.

#### ***Economic Conditions***

Because of their effect on the demand for goods, changes in economic conditions affect prices. Recurring cyclical fluctuations with alternating periods of recession and prosperity have always been a characteristic of the American economy. The severity and length of these fluctuations varies from time to time, but the basic cyclical pattern remains. Each fluctuation, whether major or minor, affects the demand for goods to some degree because of its effect on personal income and consumer confidence. Since no satisfactory method has been devised to predict a change in the direction of economic fluctuations (the point at which the top or bottom of a cycle has been reached), manufacturers and middlemen find themselves with a supply of goods in excess of demand at the start of a business decline and with an inadequate supply at the start of a business rise. The attempt to liquidate excessive inventories at the start of a recession results in widespread price reductions. The shortage of goods during a period of rapidly improving business conditions results in price increases. Because of the "stickiness" of administered prices, they adjust slowly to changes in economic conditions. During the periods of rapidly rising costs often found in the upturn of the business cycle, price rises may lag far behind the need for such changes. Similarly, the reluctance to change of administered prices delays necessary price reductions at the beginning of a recession and results in build-ups of inventory to abnormally high levels.

#### **THE PRICING DECISION-MAKING PROCESS**

Pricing decisions should be made with an awareness of the company's overall marketing environment. For example, since most companies find themselves limited to a portion of the market—possibly because of geographical location, physical facilities, capital, or narrowness of product appeal—they find that they must tailor their prices to the customs and needs of the particular market segment sought. In addition, pricing decisions must be made with the company's public image in mind since unwise pricing decisions can damage, or at least unnecessarily alter, a favorable image that may have taken years to develop. Finally, price is but one element in an overall marketing strategy that includes the promotional mix and the product mix and, to achieve maximum effect from each of these elements, they must be carefully coordinated.<sup>9</sup>

<sup>9</sup> Alfred R. Oxenfeldt proposes a six-stage sequential approach to pricing to insure that the final pricing decision is related to the overall marketing plan. These major

A pricing decision is ultimately an intuitive decision. Although some of the factors affecting prices lend themselves to quantitative treatment or objective evaluation, the consumer values relating to a product are highly subjective. To the extent that these subjective factors are allowed to influence the pricing decision, the price-setter must rely on his intuitive judgment.

Most pricing decisions start with an analysis of cost for if a company is to achieve its profit-making objective, total product sales over the long run must yield an income in excess of costs. In oligopolistic industries where price competition is avoided, cost plus a "reasonable" profit may be the only factor considered in selecting prices. The inherent weakness in this approach, however, is that it is based on the assumption that costs of every product represent a distributed share of fixed costs, or overhead. Since the number of units produced and sold can often be increased considerably without increasing overhead, an increase in sales may reduce total per-unit costs by making it possible to distribute fixed costs over a larger number of units. Under these conditions, a company may gain a larger profit from a price reduction that will increase demand enough to lower unit costs in an amount equivalent to the price cut.

To illustrate, let us assume that a manufacturer of toothbrushes sells 100,000 brushes per month at 40¢ each. His total unit cost is 38¢, yielding a profit of 2¢ per unit, or \$2,000 per month. Overhead costs are \$10,000 per month, or 10¢ per unit at the 100,000 unit volume, but he estimates that he can increase production by as much as 50 per cent without increasing total overhead. In a market test he finds that a 2¢ reduction in selling price, from 40 to 38¢, will increase his sales to 125,000 brushes per month. At this new volume, the \$10,000 overhead costs can be divided among 125,000 units, and the allocated overhead cost per unit will be 8¢, a reduction of 2¢ per unit. This reduction of 2¢ in the cost per unit will equal the reduction in selling price so that the profit per unit will remain unchanged. With the increase in units sold, the monthly profit will be \$2,500, \$500 more than at the higher price.

The decision procedure described above is called break-even analysis (and is described in detail in Chapter 12). It provides a much more reasonable basis for price selection than costs at a single level of production, but to use it effectively it is necessary to introduce a highly subjective factor—analysis of demand at various price levels. For this

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elements in pricing are: (1) selecting market targets; (2) choosing a brand image; (3) composing a marketing mix; (4) selecting a pricing policy; (5) determining a pricing strategy; and (6) arriving at a specific price. This is a useful concept, but in our opinion the first three stages constitute the environment for pricing rather than stages in the pricing process. For further details on Oxenfeldt's approach, see: Alfred R. Oxenfeldt, "Multi-Stage Approach to Pricing," *Harvard Business Review*, Vol. 38, No. 4 (July-August 1960), pp. 125-133.

reason, firms that might profit from break-even analysis may stick to present costs in figuring prices.

Demand analysis, or evaluation of the market for a particular product, is potentially the most valuable single basis for making pricing decisions. The price consumers are willing to pay for a product may have no relationship to cost. Unless demand is inelastic, the number of people willing to buy a specific category of goods varies inversely with price—the lower the price the greater the demand. The analysis of demand at various levels produces a demand schedule showing the number of units that can be sold at various prices. The construction of a demand schedule requires a number of subjective estimates or assumptions about consumers' wants and preferences. This is an area of intuitive decision-making where an executive may make use of certain specific data, such as income distribution, but where the final decisions are based on his own general knowledge of the market. Even when an administrator is willing to rely on his intuitive decision-making ability to construct a demand schedule, he faces a formidable task. He must estimate the demand at all prices when he is not even certain of the demand for his product at one price. Studies of actual pricing practices show that demand analysis is rarely used.<sup>10</sup>

The relationship of a product's price to those of competitive products requires management decisions. A marketer may be able to vary his prices from competitive prices if his product is differentiated from competitive products. The difficulty lies in measuring the values attributed to his product by consumers. For some products, a small price rise will cause many customers to buy a different brand. The soap manufacturer who distributes coupons entitling the buyer to a five cent price reduction on the product hopes that this small price differential will attract many buyers of competitive products and that their brand preferences will be changed after they try his product. Yet, other products can retain consumer loyalty even with a large price differential because infrequency of purchase or the importance of quality makes the buyer unwilling to experiment. In the final analysis, the determination of how much a price may vary from that of competitive brands—if at all—depends on subjective factors.

Attempts have been made to make pricing decisions more objective by designing pricing models, but, because of the many subjective factors involved, no practical model has been developed. The number of assumptions and hypothetical relations necessary to construct such a

<sup>10</sup> Two such studies, made almost twenty years apart, are: R. L. Hall and C. J. Hitch, *Price Theory and Business Behavior*, Oxford Clarendon Press, 1939, Oxford Economic Paper No. 2; and Robert F. Lanzillotti, "Pricing Objectives in Large Companies," *American Economic Review*, December 1958, pp. 920-940.

model destroy its practical usefulness.<sup>11</sup> Pricing executives try to make their decisions as objective as possible, but their decisions are still primarily intuitive. The willingness of many companies to follow a policy of nonprice competition and, thus reduce the number of pricing decisions to a minimum is partly explained by this situation.

The price decision-making process described on the preceding pages is based on the objective of maximizing profits. Robert N. Anthony believes that profit maximization is not the dominant object of American business, and he ascribes a simpler process of making pricing decisions to the average businessman:<sup>12</sup>

He builds up a cost—including direct costs, a fair share of indirect costs, and a satisfactory profit margin; he speculates whether he can probably obtain an adequate volume at a price based on this cost; he considers competitive pressures and strategic matters; and thus he arrives at his price. He may vary the profit margin, depending on circumstances, and he may also vary the cost by changing the design of the product, but his starting point is a price based on total cost as derived from a conventional cost accounting system, not a price based on marginal cost. His reasoning is that if each product contributes a fair share toward overhead costs and profit, then he will make a satisfactory profit on the aggregate of all products.

The emphasis in this pricing process is on "satisfactory" profit rather than on maximum profit.

### SOME BASIC PRICING POLICIES

Price policies set the framework within which day-to-day pricing decisions are made. Many pricing decisions are made by a single marketing executive, but basic pricing policies are generally established by top management. Although these policies should be subject to periodic review, they represent an important part of the image a company projects to the public and are not changed frequently. The number and kinds of pricing policies vary according to the needs of the individual firm. The more important of these are described on the following pages.

#### *The General Price Level*

This very important pricing policy is often taken so much for granted that it is not expressed in writing; most firms simply follow a policy of pricing their products at the same level as competitive products. In these instances, management attempts to eliminate price as a competitive

<sup>11</sup> See: David W. Miller and Martin K. Starr, *Executive Decisions and Operations Research* (Englewood Cliffs, N.J.: Prentice-Hall, 1960), pp. 219-223 for an interesting illustration of a hypothetical pricing model.

<sup>12</sup> Robert N. Anthony, "The Trouble with Profit Maximization," *Harvard Business Review*, Vol. 38, No. 6 (November-December 1960), p. 129.

weapon, choosing to rely instead on factors such as product differences, service, and promotion.

A less common policy is that of pricing above competitors' prices. Higher-than-average prices are sometimes used to denote an impression of above-average product quality. Consumers often relate a product's price to its quality, particularly when it is difficult to judge quality at the time of purchase. In these instances, they may be willing to pay a little more money for what seems to be the better product. Higher-than-average prices also may be used to gain the cooperation of middlemen. If a manufacturer wants particularly aggressive selling and promotional efforts from wholesalers and middlemen, he may offer them above-average margins. These higher markups are passed on to the consumer in the form of higher prices, but it is expected that the increased dealer cooperation will more than compensate for the higher prices and should actually increase sales. For a brand to compete successfully at a price above the market, it must either be strongly differentiated in the eyes of the consumer so that he believes it is different from competitive brands, or it must be strongly promoted by middlemen.

Many firms, however, do follow a policy of pricing under the market. Sometimes a firm has lower costs because its product is of lower quality, and this leads it to price its product under those of competitors. At other times, a firm substitutes a lower price in place of promotional efforts (which also cost money) used by its competitors. In all cases, however, firms following this policy must either have very low costs, or be willing to accept a very low gross margin and profit per unit in the hope of radically increasing sales volume.

#### *Uniformity of Consumer or User Prices*

Every marketer must face the decision whether or not to offer uniform prices to all buyers. Fixed prices are easier to administer, but negotiated prices are the better alternative in some instances. And, if uniform prices are deemed desirable, resale price maintenance offers the opportunity for the producer to insure equal prices at retail to all consumers.

**FIXED PRICES.** Businessmen generally prefer to market products or services on a fixed price basis, that is, offering exactly the same price to all like purchasers. Most consumer goods and many industrial goods are priced on this basis in the United States today, but in some other parts of the world, particularly in the developing countries, negotiated pricing is common even for consumer goods. Fixed prices offer several advantages to the seller. First, they provide a uniform return from each sale, making it easier to forecast income and profits. Second, selling time, and hence selling cost, is reduced when it is not necessary to conduct

lengthy negotiations before each sale. And, third, all purchasers are given fair and equal treatment by the seller, reducing the danger of alienating customers because of preferential treatment of others.

**NEGOTIATED PRICES.** Despite the advantages of fixed prices, negotiated prices are common in industries where a considerable amount of money is involved in each sales transaction. It is hardly worth a consumer's or a retailer's time to bargain over the price of a pound of coffee, and the loss of an individual sale is not important enough to the retailer to cause him to reconsider his price. But, in buying an automobile, a consumer is willing to exert considerable effort to obtain a lower price. At the same time, the sale of each automobile is important enough to the dealer for him to hesitate to lose a sale because of a few dollars. The bargaining power of individual purchasers varies with the size of the transaction. In the industrial market, a large buyer generally represents a greater potential for future business than a small buyer, so a seller will make concessions to retain the large buyer's patronage. In addition, some consumers have greater bargaining power than others because of their ability to buy for cash. For these reasons, negotiated pricing exists in many industrial markets and even in some consumer goods markets. Although many sellers of durable consumer goods are reluctant to admit that their prices are not fixed, very often they "hold to" fixed prices and negotiate on the value of "trade-ins" instead.

**RESALE PRICE MAINTENANCE.** Some manufacturers wish to control the retail prices at which middlemen sell their products to ultimate consumers. There are several reasons for following a policy of resale price maintenance. The manufacturer may wish to establish a customary standard price for his product, a price with which the consumer becomes familiar. Yet, without some control, even though each retailer has some fixed price policy, the price of a given product may vary considerably among retailers. Another manufacturer may be strongly opposed to the use of his products as price leaders, since some retailers may sell a well-known brand at less than normal price to attract consumers to their stores, and to persuade them to believe that the prices on lesser-known products may be just as low. When a manufacturer relies heavily on retailers to sell his products, he is anxious to retain their loyalty; so, he protects them from the competition of price cutters by controlling retail prices. For example, many manufacturers of men's sportswear, even though they advertise their products aggressively, depend on retailer cooperation to persuade the customer to buy, for they cannot presell their products when the consumer must evaluate color, fashion, styling, and fit at the time of purchase. Another manufacturer may wish to maintain retail prices because he believes

that the price of his products bears on the consumers' evaluation of quality. For example, most manufacturers of sterling silverware are strong advocates of resale price maintenance because they think consumers judge the quality of their products at least partially in terms of price.

The proportion of manufacturers making use of resale price maintenance is small, because many manufacturers are not bothered by retail price differentials on their products, and actually welcome any pricing practice that increases the sale of their products. In addition, a price maintenance policy is difficult to administer and enforce, since most manufacturers have little or no direct contact with the retailers of their products. And, in the states that do not have fair trade laws, the manufacturer can only suggest, not enforce, retail prices.

In recent years, many manufacturers who have used resale price maintenance have found they had overestimated its importance. "Bootlegging" of fair-traded appliances by discount houses eventually persuaded a number of manufacturers to abandon their policies of resale price maintenance, because they discovered that price cutting had no harmful effect on the reputation of their products, and the increased sales volume from these new outlets compensated for loss of volume from disgruntled regular dealers.

#### *Price Differentials*

Sellers following established policies will nevertheless often vary their prices under certain different conditions. Price differentials may be based on size of purchase, type of customer, and geographical location of the purchaser and seller, and, normally, price differentials of this sort are offered to all purchasers who meet similar conditions.

**QUANTITY DISCOUNTS.** It is common practice to offer price reductions on purchases larger-than-usual. Through the use of such reductions—called quantity discounts—sellers try to increase sales by passing on to the buyers part of the savings that can result from large purchases. These savings can sometimes be considerable for it may take little, if any, more of a salesman's time to sell a very large order than to sell a small one. And the same holds for the costs of order processing, order filling and billing, and transportation costs, which will also be cheaper per unit on large shipments because of quantity rates offered by the carriers. Because of the cost reductions possible on large sales, many marketers are willing to offer price reductions to encourage large-quantity purchases.

The Clayton Act, as described in Chapter 10, restricts the use of quantity discounts. A firm planning a policy of quantity discounts must keep two restrictions in mind: The discounts must reflect actual savings; i.e., the price reduction can be no larger than the actual savings resulting from



the larger quantity ordered. And the discounts must be made available on equal terms to all like purchasers. Within these restrictions, quantity discounts offer an opportunity to reduce marketing costs and increase market penetration.

**PRICE DIFFERENTIALS ACCORDING TO CLASS OF BUYER.** A manufacturer will often sell the same product to more than one class of buyer. For example, a paper manufacturer may sell typing paper to wholesalers, to retail chain stores, and to businesses buying for their own use. Some purchasers in each of these three categories may buy approximately equal quantities on each order, and the manufacturer should sell at the same price to each of these three purchasers if his pricing policy is based solely on direct marketing costs. Other conditions, however, may make it advisable to establish different prices for each. Let us assume that 75 per cent of his sales are made through wholesalers. This channel of distribution is essential to his success, and he may be reluctant to take any action that will antagonize or threaten the wholesalers and the retailers they serve. If he offers a chain store the same price he would offer to wholesalers, it will be able to undersell the independent retailers served by the wholesalers. For this reason some manufacturers offer lower prices to wholesalers, than to even very large retail chains, regardless of the volume purchased. A company's policy on prices to different classes of customers depends, then, on the importance of each class of buyer and its relative bargaining power.<sup>13</sup>

**GEOGRAPHICAL PRICE DIFFERENTIALS.** As the distance from the point of manufacture to the point of sale is increased, transportation costs increase. The costs of supplying buyers in different geographical areas vary accordingly. These transportation costs can be handled in two ways: by passing them on to the buyer directly, or by including them in the selling price.

Transportation costs are passed on to the buyer directly by quoting him a price at the factory. Under this method, which is called f.o.b. pricing, a buyer is expected to pay all transportation charges from the factory to his premises. Because it is easy to administer and offers equal treatment to all buyers, this is the most common way of handling geographical pricing.

Including transportation costs in the selling price is called delivered pricing. In its simplest form, this pricing method provides a single delivered price in an entire market—a "postage stamp price." "Postage stamp pricing" is used by manufacturers of chewing gum and candy bars

<sup>13</sup> For a good discussion on this topic, see: Don V. Petrone, "Price Policy in Selling Through Distributors, Wholesalers, and Jobbers," *Pricing: The Critical Decision*. AMA Management Report No. 66, p. 69.

so that their products can be sold at the same prices throughout the nation. Instead of using a single delivered price for the entire market, some manufacturers divide the market into zones and set different prices in each zone, depending on the distance of the zone from the factory. Zoned pricing still permits the seller to quote the same price to a large group of buyers in a geographical region, but it allows him to divide the total transportation charges more closely in line with the actual costs incurred. A market may be divided into any number of zones. For example, some manufacturers located in eastern United States divide the nation into two zones and advertise a single price with the qualification that "prices are slightly higher west of the Mississippi." Delivered pricing is used by manufacturers who desire to maintain price uniformity in their markets. Under this policy, total transportation costs are averaged and an equal share is added to the price of each unit sold.

#### *Guaranty Against Price Decline*

A seller may offer a guaranty against decline in prices in order to persuade buyers to buy quantities in excess of their immediate needs. For example, air conditioner manufacturers have a seasonal market covering less than six months of the year, but they can reduce production costs by producing air conditioners all year. In an effort to reduce investment in finished goods inventory during the non-selling season, an air conditioner manufacturer may offer distributors special discounts for preseason purchases. But if a distributor thinks there is a possibility of price reductions in the industry before the selling season, even a discount will not persuade him to buy. To overcome this fear, the manufacturer may agree to refund an amount equal to any price declines before some specified date. Guaranties against price declines are also used commonly on products whose prices fluctuate rapidly.

#### *Outright Sale or Lease*

Leasing offers an alternative to outright sale of goods. Several conditions may cause a buyer to find leasing an attractive alternative to purchasing. When a product has an unusually high rate of obsolescence, the product user can, by leasing, avoid the cost of premature write-offs. Complex products requiring continuous and expert servicing and maintenance are sometimes leased because the users wish to avoid this responsibility. The product user who wishes to minimize his investment in fixed assets can accomplish this through leasing. Complex computers are often leased because of all three of these reasons: rapid obsolescence, extensive maintenance, and high cost. The leasing of fleets of automobiles and trucks, a rapidly expanding business practice, appeals to users primarily as a means

of reducing capital investment, but it also simplifies maintenance problems and often reduces maintenance cost.

A seller's decision to lease rather than to sell his products depends on several factors. Leasing requires a large capital investment in inventory, and it should produce as high a net return as other possible uses of the capital. The lessor is ordinarily responsible for maintaining the goods in operating condition. The manufacturers of some products—computers, for example—must assume the maintenance responsibility anyway because most users do not have the necessary facilities or personnel. And, when maintenance becomes an added responsibility of the seller simply because of leasing, the rental income must be enough to cover the cost. Sometimes, buyers are reluctant to invest in expensive equipment because of rapid obsolescence and leasing may be the only way a manufacturer can place his product in the hands of users.

In the rare instances where a producer enjoys a temporary monopoly because of patent protection, leasing may offer a means of maximizing profits, for the total rental-income over the life of a product may considerably exceed the maximum price a buyer would be willing to pay. Of course, this method of maximizing profits through leasing is not available when competitors can sell a similar product outright.

#### *Participation in Competitive Bidding*

Under the practice of competitive bidding, a buyer asks two or more competing suppliers to submit bids on a proposed purchase or contract and, after receipt of the bids, awards the business to the bidder offering the best proposal. A proposal may be selected as best for a number of reasons—e.g., price, delivery dates, reputation for quality—depending on what is most important to the buyer. Competitive bidding is restricted almost entirely to the selling of industrial goods, and is used most frequently on expensive installations and special order goods, such as manufactured parts or subassemblies for the buyer's finished product. Special order goods have a wider than normal potential price variation because the suppliers who are asked to quote a price have no opportunity to compare with the prices of competitors, as they can with standard products sold on the open market. For this reason, buyers may find it to their advantage to ask for competitive bids. In the case of expensive installations, the individual sale is important enough that the seller may be willing to shade his price to obtain the order. Competitive bidding provides the machinery to achieve this price bargaining. In addition, government purchasing agents at all levels of government are ordinarily required to request competitive bids on most of their purchases.

In some industries, competitive bidding is the general rule and indi-

vidual manufacturers have virtually no choice but to participate. But in other industries, only a part of the volume is sold on this basis, and each manufacturer must decide whether it is to his advantage to participate. For example, a typewriter manufacturer who sells to industry on a uniform price basis must participate in competitive bidding if he decides to seek orders from governmental agencies. Since many sellers believe that competitive bidding reduces competition almost entirely to a price basis, they may prefer to avoid this kind of business, unless the share of the total market involved is too large to ignore.

It is probably true that price has a greater influence on the buying decision under competitive bidding than under other pricing methods, but it does not follow that other factors, such as product differentiation, promotional activities, and service cease to be important. Contracts are frequently awarded to other than the lowest bidder because of one or more of these factors. An effective salesman can often remove competition from government bids by persuading the purchasing agent of the value of a differentiating characteristic of his product so that he will include this characteristic in his written specification. In effect, this eliminates competitive products from consideration. In many instances, the agent may pass over the lowest bids to buy from a supplier whose product and servicing have been demonstrated to be superior. Also, in nongovernmental bidding the purchaser will sometimes allow a favored supplier to meet the lowest bid of a competitor.

When all other factors are equal, awards are made on the basis of price. For the seller, the difficulty in these situations is in selecting the price that will maximize potential profit. Too low a price may eliminate profit or reduce it to an unacceptable level, and too high a price will decrease the probability of receiving the award. Miller and Starr have designed a competitive-bidding model for determining the optimum bid.<sup>14</sup> Using maximum immediate profit as a marketing strategy, the following formula can be derived:

$$\text{Expected profit} = p(x - c)$$

In this formula,  $p$  = the probability of receiving the award,  $x$  = the amount of bid, and  $c$  = cost of fulfilling obligations under contract. The difficulty in this model lies in the determination of the probability of award. To prepare a table of probabilities, it is necessary to analyze the past actions of competitive bidders on other bids. The collection of the data necessary for use of this model is a big task, but if the model is used, it reduces the uncertainty in selecting the best bid.

<sup>14</sup> See: David W. Miller and Martin K. Starr, *op. cit.*, pp. 223-238 for a complete description of this model.

**PRICING STRATEGY**

Although the distinction between pricing policy and pricing strategy is not always a clear one, there is a clear distinction as they are used in this book. Policies deal with situations of a recurring nature that can be predicted and expected, and strategy deals with special situations of a non-recurring nature, for which policies have not been formed.

In setting pricing strategy, management ordinarily tries to find a solution to conform to the overall marketing program, promotional mix and pricing policies. Thus, if a large and aggressive new competitor enters the market, a new pricing strategy may be necessary to counter the competition. If the new company continues to upset the pricing structure over a period of time, a new pricing policy may become necessary. In some situations it becomes necessary to depart from normal pricing policy to adjust to a special situation.

A large number of American businesses faced this kind of special situation for a number of years after 1958. For many industries this was a period of almost stable prices, even during the business upturn of 1961. This stability has been explained by the increasing number of businesses operating below capacity, the slower overall rate of growth of unit sales volume in most industries, and the increasing strength of foreign competition. The stabilizing effect of all factors on sales volume has made businessmen reluctant to raise prices, even to cover higher costs. For those companies accustomed to setting their prices on the basis of cost, this has involved a new pricing strategy. Some experts claim that this is not a temporary situation: "An analysis of price trends by companies and by products suggests that more and more companies are having to do business in a competitive context in which it is no longer possible to adjust prices to absorb increasing costs and, by doing so, to maintain or increase their levels of profit."<sup>15</sup> These companies have had to change their bases for computing prices from "cost plus" to "what the market will bear." If the situation remains unchanged indefinitely, what started out as a temporary pricing strategy may end up as a permanent change in the basis used for establishing prices.

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<sup>15</sup> J. Roger Morrison and Richard F. Neuschol, "The Second Squeeze on Profits," *Harvard Business Review*, Vol. 40, No. 4 (July-August 1962), pp. 58-9.

**CONCLUSION**

Most prices today are administered prices, resulting from management decisions rather than the interplay of natural forces. Costs set a lower limit on prices, and these data are fairly objective, but other factors affecting prices are highly subjective. Thus, the pricing decision is an intuitive one.

It is important to remember that the price setter works within a social framework. His actions are guided to some extent by society's assessment of a fair price. For example, businessmen are subject to pressure from society and, through society, from government to postpone price increases in time of inflation. Failure to recognize such pressures can result in consumer dissatisfaction and even government interference. The public furor over the rise in steel prices in April, 1962 is a case in point.

#### QUESTIONS AND PROBLEMS

1. Administered prices, if widespread within an industry, are likely to lead to collusion and monopolistic practices. Do you agree? Why or why not?
2. Why do you suppose so many producers rely primarily on cost rather than market factors as the basis for setting prices on their products?
3. Can you relate contribution to overhead to the willingness or unwillingness of producers to sell a part of their output to middlemen for private branding?
4. Is long-run profit the most satisfactory criterion in setting prices? Why is it not used more than it is?
5. Since elasticity of demand applies to industries rather than to the products of individual firms, demand elasticity should not be a factor in the pricing decisions of individual firms. Discuss this statement.
6. Why are producers generally much more reluctant to use price than promotion as a competitive weapon?
7. The existence of administered prices tends to increase the impact of economic fluctuations of price levels. Would you agree that this is true? How?
8. Pricing above the market is less likely to be successful with products sold in self-service than in full-service stores. Why?
9. Explain why negotiated prices are more characteristic of the market for industrial goods than consumer goods.
10. Would you agree that resale price maintenance is clearly to the disadvantage of the consumer? Explain your answer.
11. It is clearly unethical, if not illegal, for a manufacturer to sell his products at lower prices to wholesalers than to retailers under equal conditions. Do you agree? Explain.
12. In your opinion, do the advantages to the manufacturer of using delivered pricing outweigh the disadvantages of this pricing policy? Explain.

- 13. The decision to use leasing rather than outright sale as a pricing policy is really a financial, not a marketing, decision. Please comment.**
- 14. Purchasers who insist on buying on the basis of competitive bids often eliminate their best sources of supply because these sellers won't be bothered with bidding. Is this probably true? Why should a producer deliberately avoid large sales to governmental agencies required to buy on this basis?**
- 15. Would you agree that the competitively strongest businesses are more likely to prefer a fixed price policy, and the weakest prefer to negotiate prices? Explain.**

## A D V E R T I S I N G

# 19

When he comes to consider his advertising needs, the marketing decision-maker finds himself faced with many challenging problems. The most basic of these is whether the company should advertise at all, and only if he knows what advertising can and cannot do will he be able to reach a rational decision. If he decides to advertise, he will have to make several related decisions. Should the firm handle all of its own advertising, or should an advertising agency be retained? Which advertising agency should be selected? How much money should be invested in advertising? What measures of advertising effectiveness should be used? How should the advertising appro-



priation be allocated among the different media that will be used? Should the firm engage in cooperative advertising? These and other important decisions will have to be made.

Our main focus in this chapter is on the management of advertising effort. Because of their specialized nature which makes them subjects more properly covered elsewhere, such technical details of advertising production as copy, layout, illustration, and type styles do not enter the discussion.<sup>1</sup> Certainly it should not be inferred that it is unimportant for the marketing decision-maker to be familiar with the technical side of advertising, for such knowledge is very important to him, particularly when he must consider the appropriateness of copy, layout, and the like, in relation to the company's advertising objectives.

#### ENVIRONMENT FOR DECISION-MAKING

Advertising is largely wasted unless full account is taken of the environment in which it is applied. Essentially, advertising is a controllable marketing factor, but it is applied within a framework made up of a host of uncontrollable marketing factors. These include such elusive ones as the differing psychological makeup of consumers, the economic and non-economic motives causing them to buy or not to buy, and the influences of various kinds of group pressures.

Within the company itself, advertising decisions influence and are influenced by decisions on other marketing and non-marketing factors. Advertising decisions and decisions on the nature and direction of personal selling effort are inextricably linked, and both groups of these decisions, in turn, are tied to those in such areas as pricing, distribution channels, and physical distribution management. Furthermore, advertising decisions are linked to financial decisions as, for example, in the decision on what amount will be invested in advertising.

#### ADVERTISING AND PROFIT

The long-term objective of advertising, as of every other business activity, is to increase the firm's net profits over what they would be without it. In some cases increased profits are clearly also the immediate goal, but in others this is not as apparent. Specific advertisements and campaigns, for instance, are often aimed at such immediate goals as these: obtaining "leads" for salesmen, paving the way for salesmen's calls, maintaining customer contact between salesmen's calls, securing new dealers and dis-

<sup>1</sup> The reader interested in the technical aspects of advertising production is referred to any of the many basic texts in that field. Among these, are: O. Kleppner, *Advertising Procedure*, 4th ed. (New York: Prentice-Hall, 1950); C. H. Sandage and V. Fryburger, *Advertising Theory and Practice*, 5th ed. (Homewood, Ill.: Richard D. Irwin, 1958); and H. W. Hepner, *Modern Advertising Practices and Principles* (New York: McGraw-Hill, 1956)

tributors, compelling present middlemen to continue handling the product, building lists for direct-mail advertising, and inducing purchase of a product of which the advertiser's product is a component.<sup>2</sup> But these short-term objectives, if achieved, are likely to contribute to increased net profits over the long-run. Thus, the quest for greater profits provides the principal, if not the only, motivation underlying the advertising efforts of most businesses.<sup>3</sup>

### APPRAISING THE ADVERTISING OPPORTUNITY

Should a firm advertise a particular product? The answer is "Yes, if there is sufficient opportunity for improving the firm's net-profit position." An "advertising opportunity" is present when the use of advertising is capable of bringing about an increase in sales large enough to cover all added costs involved in handling the added volume of sales (including advertising costs) and still have enough left over to make a contribution toward net profit. Thus, in a firm operating at a ten per cent rate of profit, a proposed \$10,000 advertising program would constitute an advertising opportunity only if it could be expected to increase sales volume by more than \$100,000, since the added cost of advertising would eat up the profit on the first incremental \$100,000 of sales.

Determining the presence and extent of an advertising opportunity is not easy, and sometimes the only way is just "to try it and see." But most advertisers need not resort to trial and error if they have sufficient and reliable information on which to base rational decisions. Detecting advertising opportunity requires rigorous qualitative analysis of the market, the product, and the distribution system. Measuring the extent, or size, of the advertising opportunity requires much additional information, most of it quantitative.

### *Kinds of Advertising Opportunity*

There are two broad categories of advertising opportunities. First, there are opportunities to stimulate primary demand—i.e., demand for the type of product apart from specific brands (e.g., demand for electric refrigerators apart from demand for *Norge* or *Kelvinator* or other brands of refrigerator). Relative to the product life cycle, then, stimulation of primary demand precedes stimulation of selective demand. Consumers must want

<sup>2</sup> This by no means exhausts the variety of advertising's immediate goals. For a more extensive listing, see A. W. Frey, *Advertising*, 2nd ed. (New York: Ronald Press, 1953), pp. 14-15.

<sup>3</sup> However, this is not to deny that certain businesses devote some advertising dollars to such purposes as: influencing public opinion during strikes, promoting facilities, and building the corporate image. Even here, though the relation of immediate purpose to long-term profit is less direct and probably impossible to measure, it is still true that greater profits in the long-run provide one of the chief motivations for the advertising.

the generic product (as marketing people generally describe a type of product) before they can want some brand of it. Thus, after introducing a new kind of product, a manufacturer will normally concentrate on advertising intended to stimulate primary demand. As the product type gains acceptance, the manufacturer may gradually change over to advertising that is designed to stimulate selective demand. For example, when R.C.A. introduced color television, it was the only manufacturer, and its total promotional efforts were devoted to persuading consumers to buy color instead of black and white television. After General Electric, Zenith, and other television manufacturers entered the color television field, R.C.A. changed its advertising to emphasize the special advantage of R.C.A. color television over competitive color sets. Many products, however, continue to require advertising aimed at stimulating primary demand because they are in direct competition with some different product type. For example, tea, certainly not a new product, must continually compete with coffee for primary acceptance. In other situations, the product type may be in indirect competition for the consumer's dollars. For example, home organs and color television sets both may compete for the same individual consumers' dollars when they cannot afford to buy both. It is not unusual, then, for primary demand advertising to be used even for "mature" products. But in all cases, primary demand must exist before selective demand can be stimulated.

#### *Nature of Demand*

If advertising is to result in additional net profits, it usually must produce additional sales volume. However, additional net profits may also result if advertising just proves to be a more economical means of getting business than personal selling. In either situation advertising must be capable of causing sales, or else there is no justification for advertising.

If demand can be stimulated through advertising alone, it is said to be "expansible."<sup>4</sup> Demand expansibility should not be confused with demand elasticity, as defined in Chapter 18, which describes a situation where changes in price will affect demand. Demand is expansible if an increase in advertising results in greater sales of the product or brand with no change in price. If it does not, or if the price must be cut to produce additional sales, demand is inexpandible. To stimulate primary demand on a profitable basis, then, demand must be expansible. An expansible demand is not a necessary condition for the profitable stimulation of selective demand, inasmuch as selective demand advertising may succeed in winning

<sup>4</sup> The expansibility-of-demand concept was first used by Professor M. T. Copeland in his marketing course at the Harvard Business School in the mid-1920's. Some writers use another term, promotional elasticity, when referring to demand expansibility. For instance, see: J. Dean, *Managerial Economics* (Englewood Cliffs, N.J.: Prentice-Hall, 1951), pp. 161-163.

away customers of competing brands. Nevertheless, the existence of an expansible demand adds to the chances of success for selective, as well as primary, demand advertising. Moreover, advertising designed to stimulate selective demand may win non-users of the product type to the manufacturer's brand, may win some users of competing brands, and may even increase consumption of the brand among its present users.

In considering demand in relation to advertising opportunity, a decision-maker must also know whether demand is elastic. As we brought out in the chapter on pricing, elasticity refers to the responsiveness of consumers at a given time to changes in the price of a product or brand. Demand is elastic if a price reduction increases total revenue (price times quantity sold), and if a price rise reduces total revenue. Demand is inelastic if a price reduction decreases total revenue, and a price rise increases total revenue. Normally, however, and contrary to the economist's usual assumption, the adjustment of revenue to a price change is not immediate. So a practical businessman may find advertising useful in "spreading the word" of a price reduction on a product with an elastic demand, for instance, and thus speed up the receipt of increased total revenue.

#### *The Product and Basic Consumer Wants*

Marketing men have long recognized that if a product will not sell without any advertising, the product will not sell with advertising. For a product to sell at all, with or without advertising, it must appeal to and satisfy the wants of some consumers, at least as well as competing items. Some advertisers, dazzled by the more spectacular findings of motivation research, come to believe that consumers can be trapped into buying through appeals made to "unconscious" buying motives, regardless of the worth of a product. This was a main theme in Vance Packard's *The Hidden Persuaders*,<sup>5</sup> which strongly implied that motivation research was, in effect, being used to manipulate people to the commercial advantage of advertisers.<sup>6</sup> The plain fact is that advertising possesses no magic capable of causing people to buy things they do not want, even when it is based on the most sophisticated motivation research. However, it may help them rationalize purchases of products they want but do not need in a strict economic sense. Who "needs" custom-made shirts at double the price of factory-made shirts? Only a small percentage of men who require unusual sizes actually need custom-made shirts, but many men want them for prestige reasons. Appeals to these other wants help consumers to rationalize uneconomic but satisfying wants. Yet, to a far greater extent than

<sup>5</sup> New York: David McKay Co., 1957.

<sup>6</sup> For an analysis of this proposition and as an antidote to *The Hidden Persuaders*, see: R. A. Bauer, "Limits of Persuasion," *Harvard Business Review*, Vol. 36, No. 5 (September-October 1958), pp. 105-110.

many advertisers realize, the buying behavior of most consumers is based on rational buying motives.

It is true that some people buy some products for irrational reasons—reasons which they are either not willing to admit to themselves, or that they are not willing to admit to others.<sup>7</sup> But even for such products, presumably the ones whose advertising might benefit the most through incorporation of “hidden” buying appeals, consumers are prone to buy the product sooner and “feel better about it” if they are given an added rational reason for buying. On this point, Bursk says: <sup>8</sup>

... of two ads, both of which apply to a product mainly bought for *irrational* reasons, the one that provides in addition some cogent rational reason should produce a stronger reaction than the one that does not. I suspect that one explanation of why the combination of an advertising appeal to the image of masculinity *and* a new crush-proof box worked so well for Marlboro cigarettes is that the box offered a generally acceptable rationalization.

Most buyers command only limited purchasing power and this places a powerful constraint on irrationality. The buyer who is spending all of his income on food and housing must make fairly “rational” decisions. He must choose between alternatives that will meet his basic physical needs. Even with a very high level of real income in the United States, two forms of scarcity persist. Some consumers are truly poor in an economic sense and must carefully divide their purchasing power among alternative buying options in order to sustain little more than a subsistence standard of living. Those with higher incomes are still sufficiently limited in purchasing power, relative to their levels of aspiration, for them also to place a high value on rationality in buying.<sup>9</sup>

In appraising a product in relation to whether or not an advertising opportunity is present, the really important questions to ask are these: “Do potential buyers have needs which this product or brand is capable of satisfying?” and “How important, or how strong, are these needs of potential buyers?” If there are strong basic needs for the product, the chances are that considerable opportunity for profitable advertising exists. If the product is capable of satisfying only comparatively weak and less basic needs, there is not nearly so much opportunity for profitable advertising. The extent of the advertising opportunity varies with the strength of the basic underlying needs that are satisfied by the product or brand.<sup>10</sup>

**Brand Differentiation**

A particularly important factor in appraising advertising opportunity is the degree to which the brand differs from competing brands. Brand differences and similarities should be identified, and appraisals made of their relative importance to specific market segments. Differences that large numbers of consumers consider important furnish the source of selective-advertising appeals. If a brand is not very different from competing brands—and consumers know it—the most the manufacturer can hope to accomplish through advertising is brand acceptance. There must be brand differences of substantial importance to consumers if the advertising is to be successful in developing brand preference or, ideally, brand insistence.

Consumers can detect some important hidden brand differences through use; other hidden brand differences can not be detected through use. If, as in the case of many food products, the detection of hidden differences requires that the brand be used in a certain way, the manufacturer must provide directions for use. Thus, the manufacturer of a cake mix provides careful directions to insure that the end product is an acceptable cake. If, as is true of certain drugs and cosmetic items, the hidden difference is not detectable through use (e.g., it may require a number of weeks of use of a facial cream to determine that it has a bad effect on the complexion) the advertiser often attempts to convince consumers of the integrity of the firm itself, or publicizes endorsements of the brand by experts. Whenever a brand possesses important hidden differences, there is considerable opportunity for advertising to exploit them profitably.

**Price**

For a favorable advertising opportunity to exist, consumers should consider the product or brand worth the price it is necessary to charge (including advertising costs). This does not necessarily mean that the advertised item should be priced identically with its unadvertised competitors, or even its advertised competitors. The price should represent reasonable value for the brand in the mind of the consumer. If he considers it superior to competing brands, the price may be higher, and if he considers it inferior, the price must be lower. Advertising will not persuade the consumer to pay what he considers an unreasonable price. Yet, many consumers evidently feel that an advertised brand is worth a higher price than an unadvertised brand, because they are more confident that they are buying what they want. Manufacturers of nationally advertised brands are particularly careful to maintain consistent quality and service in order to retain the loyalty of customers. Many consumers are willing to pay a slightly higher price for Swift's bacon than for an unknown brand, because

they know it will taste the way they expect it to taste. To illustrate this, a research organization reports: <sup>11</sup>

... the consumer is generally willing to pay substantial price premiums for advertised brands. Just a casual examination of prices reveals such figures as a 45% price premium for an advertised brand of men's socks, 36.5% for women's nylons, 37.5% for men's electric shavers, 35% for portable typewriters, 33% for an advertised brand of interior wall paint, 27% for men's shorts, 27.5% for children's jeans. Customers pay up to 41% more for the advertised brand of a food product and premiums of 100% or more for the advertised brand of a standard drug product listed in the U.S. Pharmacopeia.

Beyond the premium a consumer is usually willing to pay because of his confidence of consistent benefits from the advertised brand, the price of the advertised brand may exceed the price of the unadvertised brand only by an amount equal to the value consumers place on the additional advantages of the advertised brand. The consumer may determine this added value by personal observation and testing or by acceptance of the claims of the advertiser when he is unable to observe and evaluate the differences for himself. If the advertised brand has no important differences, hidden or otherwise, its price can be no higher than those of its unadvertised competitors. This principle is well illustrated in the report of a study of prices of advertised and unadvertised brands in 34 selected typical food store product groups: <sup>12</sup>

The range of added consumer values among the 34 groups extends from zero to 41%. The latter figure traces to a rather unusual situation involving a very sharp upgrading in both product quality and price on the part of certain advertised brands in one of the 34 groups. The zeros trace to certain instances where the product differentiation between advertised and non-advertised brands is virtually nonexistent. The median or most representative figure for added consumer value for all 34 typical food product groups is 13%, which can be interpreted to mean that the consumer is willing to spend 13% more for advertised brands...

... the product groups with the higher added consumer value for advertised brands are those where there have been rather marked product improvements and/or added convenience in use. On the other hand, the product groups at the lower end of the list are those canned or packaged commodities where brand differentiation is, for whatever reason, rather slight. .

#### *Incremental Return and Advertising Cost*

To justify advertising a brand, potential dollar sales should be great enough to produce at least enough additional gross margin dollars, excess

<sup>11</sup> J. O. Peckham, "The Added Consumer Value of Advertised Brands," *The Nielsen Researcher*, November-December 1958, p. 4.

<sup>12</sup> *Ibid.*, p. 6.

of sales over cost of goods sold, to cover cost of advertising. In other words, advertising should pay for itself. To be profitable, it must bring in more than enough extra gross margin dollars to cover its cost. There is a sort of break-even point for advertising, a point where additional gross margin dollars resulting from the advertising just barely pay for the advertising. Thus, the decision-maker should calculate the additional sales volume that the advertising should produce in order to break even on the advertising cost. This is a matter of dividing the cost of an adequate advertising campaign by the gross margin per unit of product (excess of selling price over cost).

Therefore, the amount of unit gross margin obtainable is a significant factor to consider in appraising advertising opportunity. The size of unit gross margin is related to such marketing characteristics of the brand as its replacement rate and consumption time.<sup>13</sup> A brand with a high replacement rate (purchased frequently by consumers) and a low consumption time (used rapidly by consumers) usually has a low unit gross margin. Conversely, a brand with a low replacement rate and high consumption time normally has a high unit gross margin. In either case, there may be economic justification for advertising. However, a brand characterized by a low replacement rate and high consumption time must also be salable at a fairly high unit price in order for advertising to pay for itself. A low-priced pocket knife, unless it can be sold in much higher volume is not nearly as promising a candidate for advertising as a higher-priced set of carving knives, but both have low replacement rates and high consumption times.

#### *Amount of Advertising Expenditures Required*

The cost of an adequate advertising campaign not only affects the advertising break-even calculation but is often in its own right a major determinant of whether or not a company should advertise. Since advertising is but one part of the total promotional budget, the amount of money allocated to this promotional method will be developed as a part of the overall promotional plan. The share allocated to advertising must, then, be allocated among the various media selected on the basis of media rates and advertising messages planned. According to one author, this job of estimating and allocating the costs of an adequate advertising campaign requires four steps: <sup>14</sup>

- (1) Determine what burden is to be placed upon consumer advertising in the selling program and what burden is to be placed on other selling methods.
- (2) Decide what media are to be used to carry the advertising message

<sup>13</sup> For explanations of replacement rate and consumption time, see Chapter 2.

<sup>14</sup> J. D. Scott, *Advertising Principles and Problems* (New York: Prentice-Hall, 1953), p. 86.



to the prospective buyer. This will involve finding answers to such questions as: Who are the prospective buyers? Where are they located? How many prospects are there? How is the product to be distributed to them? (3) Work out the advertising schedule. To do this, decisions will have to be made on how large an advertisement, or how much radio time, is necessary in order to get the prospect's attention. How frequently should advertisements appear? How many advertisements should be used? (4) Through the use of *Standard Rate & Data*, showing space and time costs for publications and radio stations (and other media), estimate the cost of advertisements on the schedule.

With an estimate of the costs of an adequate advertising campaign on hand, the decision-maker needs next to determine whether the company can afford the expense. This, of course, depends partly on the potential ability of the advertising to return enough additional gross-margin dollars to pay for the advertising. But it also depends on the funds the company has available to spend for advertising. If there is not enough money to support an adequate campaign, it is generally best not to advertise at all and to concentrate instead on other selling methods.

Whether the sales resulting from the advertising are immediate or deferred is also significant. If advertising results in immediate sales, the costs of advertising may be met largely as they are incurred from the greater number of gross-margin dollars available. If the advertising investment pays off only over or after a considerable period, financing the advertising will require a much larger outlay. Companies short of working capital are often able to advertise under the first condition, but not the second, this, in turn, causes them to use campaigns designed to result in immediate rather than deferred sales. Better financed companies may choose advertising designed to produce either immediate or deferred sales or both, depending on the relative attractiveness of the different payoffs.

#### *Distribution of the Brand*

If prospective buyers are influenced by the advertising, but are unable to find stores where the brand is on sale, sales will not be made, advertising dollars will be wasted, and ill will toward the advertiser may be the only result. For advertising to attain maximum effectiveness, people influenced by it must be able to find stores where they can buy the brand. This is a matter of having the proper sort of distribution, considering the time consumers are willing to spend looking for the product. If consumers will spend only a little time looking for the product, its distribution should be widespread. If consumers will spend considerable searching time on the product, its distribution can be more selective. Company policy on distribution intensity should be closely correlated with the coverage of the proposed advertising.

Even with proper distribution intensity, sales and goodwill may be lost

if dealers do not carry sufficient stocks of the brand to meet the increased demand which should result from the advertising. So, to prevent such out-of-stocks from developing, the manufacturer should make certain that dealers know of the anticipated sales increase before the advertising appears. He should also see to it that dealers are able to obtain re-orders promptly.

#### *The Decision to Advertise*

Thorough analysis of a firm's marketing situation in relation to the foregoing factors usually reveals some conditions favoring advertising and others against it. Generally, advertising opportunity is influenced more by combinations of conditions than it is by any single favorable or adverse factor. Advertising always entails some risk, but total risk is certainly less the more the favoring conditions outweigh those opposed to advertising. As the proportion of adverse to favorable conditions increases, the risk of advertising failure increases. After evaluating the relative risk and determining whether this is a reasonable amount of risk for the firm to assume, the decision-maker decides whether to advertise.

#### **ADVERTISING AGENCIES**

Assuming that the company plans to advertise, the decision-maker must next decide who will do the actual work of advertising. Who should prepare the advertising program and the different campaigns? Who should write the copy, develop the appeals and themes, do the illustrations, and select the type styles? Who should determine the size and position of advertising space, arrange for the use of various media, write and produce radio and TV commercials, choose the programs to sponsor, and draft the master advertising schedule? These are some of the many related tasks involved in the actual work of advertising.

The advertiser must choose either to have his own organization do this work, or to arrange for it to be handled by an advertising agency. Whether the company should have its own pool of advertising talent or tap the skills of an agency depends on who can do the job best and most effectively. If advertising dollars are to produce the maximum possible impact on sales and profits, all elements in the program must be skillfully prepared and carried out. The responsibility for the success or failure of the advertising, however, does not lie with the advertising agency but rather with some executive in the firm itself, generally its advertising manager. This assignment of responsibility holds whether the firm's own advertising department discharges the entire task of advertising, or whether all or parts of it are handled by an advertising agency. In the remainder of this section, we will consider some of the things an advertiser should consider in deciding whether to use an advertising agency.

*Function and Compensation of Agencies*

The president of the American Association of Advertising Agencies defines an advertising agency as "an *independent* business organization composed of *creative and business* people who *develop, prepare and place advertising* in advertising media for *sellers seeking to find customers* for their goods and services." <sup>15</sup> Another professional advertising man, president of an agency and a noted writer, sums up the functions of a modern agency as follows: <sup>16</sup>

The job of the advertising agency is to plan, create, and place effective advertising. To help further this work, the agency may provide many collateral services. Some of these services, such as giving marketing counsel, are directly designed to help plan advertising more effectively. Some, such as conducting copy tests, are designed to help conceive it more effectively. Still other services, like the preparation of material that the salesman and dealers can use in conjunction with the advertising, are designed to make the advertising more productive after it has appeared. These collateral services may vary with the requirements of the particular account, but the final measure of any agency's professional stature derives from its ability to create effective advertisements

Thus, an advertising agency is a group of experts on various phases of advertising and related marketing problems. In its operations, it resembles other organizations providing expert assistance on specialized business problems. The agency resembles the management consulting firm, the marketing research firm, and the firm that specializes in the design and administration of incentive campaigns for salesmen and dealers. But in the way it normally receives its compensation, the advertising agency is distinct from other consulting organizations.

The "commission system" is the traditional and still the most widely used method of compensating advertising agencies. Agencies pay for space and time used on behalf of advertisers at the "card rate" less a certain discount, usually 15%, and bill them at the card rate. Thus, agencies receive their basic compensation from advertising media rather than from advertisers, and this has been the source of considerable argument.<sup>17</sup>

Advertisers, especially large ones, maintain that agencies may overspend for media use, simply because so much of their compensation comes

from media commissions. Of course, the advertising agencies, over the years, have been the most steadfast defenders of the commission system. But more and more agencies have lost their liking for it. Part of the disenchantment traces to the consent decree entered into by the American Association of Advertising Agencies in 1956, resulting from an antitrust suit brought by the U.S. Department of Justice, which in effect made it possible for media to grant commissions to other than "recognized" agencies, and in general made the commission system more difficult to enforce and more open to attack.<sup>18</sup>

Even more of the agencies' disaffection for the commission system results from the increasing costs of providing a wide range of services to advertisers. Among the services some agencies now provide for their clients are: assistance in pretesting advertisements, in carrying out test marketing operations and performing local advertising tests; preliminary market testing of new products and research on advertising effectiveness; and marketing counsel and aid in marketing research. At one time, agencies performed such services "free," and some continue to do so, especially for advertisers with large media budgets subject to commissions. But there is a growing tendency to bill advertisers for these "extras" on a "cost plus" or fee basis. Fees and charges, as distinct from commissions, currently amount to about one third of the gross incomes of advertising agencies.<sup>19</sup> Some agencies have agreed to replace the traditional commission system entirely with a fee arrangement under which media commissions received are credited toward payment of the agreed fee.<sup>20</sup> Thus, as commissions have declined in relative importance as a source of agency compensation, a growing number of agencies have become more inclined to enter into other compensation arrangements with advertisers.

#### **Advertiser-Agency Relationships**

Through long-standing practice, certain relationships between advertisers and the advertising agencies have become standardized. The five most important are as follows: First, the agency refrains from having two accounts whose products are in direct competition. Second, the advertiser, for his part, normally refrains from using two agencies to handle the advertising for the same product. Third, the agency obtains the advertiser's advance approval before it commits him to expenditures. Fourth, the advertiser pays media and other invoices promptly and

<sup>18</sup> For a report on the specific provisions of this consent decree, see: *Advertising Age*, February 6, 1956, pp. 1 ff.

<sup>19</sup> F. R. Gamble, "Advertising Agency Costs & Profits," *Harvard Business Review*, Vol. 37, No. 6 (November-December, 1959), p. 106.

<sup>20</sup> See: "Wide Crack in 15% Agency Fee," *Business Week*, November 26, 1960, pp. 47-48.

within the cash discount period. And fifth, the agency passes on to the advertiser the exact dollar amounts of all discounts granted by media.

### ***Advertising Skills***

The decision on use of an agency often depends on the number and variety of skills required to carry out an advertising program. In contrast with advertising agencies, few manufacturers can afford to have in their employ all of the different talents needed to develop and produce large-scale advertising programs. Characteristically, too, agencies allow much greater latitude for creative activity than is normally found in a manufacturer-controlled advertising department. Creative people in agencies may give freer rein to their imagination because they do not work directly for the advertiser. It is usually the agency team which is able to see the need for, and the way to, a break with the manufacturer's custom and usage and produce advertisements and campaigns which are fresh and original. The Doyle Dane Bernbach agency made such a sweeping change in the advertising for Warner foundation garments when they took over this account in the fall of 1961.<sup>21</sup> Prior to this time, the firms in the foundation garment industry, of which The Warner Brothers Company is one of the top three, had followed almost identical approaches, using the same kind of art and stressing the same kind of appeals, such as stretch, uplift, and bulge control. No single company's advertisements stood out from its competitors' ads. The introduction of a new material, Lycra, in Warner's garments provided the opportunity for a fresh advertising approach, since Lycra takes dyes much better than rubber. The ad agency proposed a new cosmetic approach, emphasizing color and adding an aura of glamor to the foundation garments. In just one year's time, readership of Warner's ads was up; sales, in general, were climbing; and sales of the new colored garments had increased two and one-half times. When proposed new campaigns such as this are big ones and ones requiring the application of considerable skill, an outside agency is more likely to obtain their adoption than a manufacturer-controlled advertising department.

### ***Selecting an Advertising Agency***

Selecting an advertising agency is by no means easy, for there are no standardized selection procedures appropriate for all cases.<sup>22</sup> A manufacturer decides to use an agency mainly because he wants additional talent to help him plan and carry out an advertising program. The problem of

selection, then is effectively one of evaluating the skills and capacities of individuals who will be working on the account. Thus, evaluating the qualifications of competing agencies involves comparisons of their respective pools of talent. In appraising the probable usefulness of different agencies, an advertiser should for each agency investigate the backgrounds and professional qualifications of the key personnel who may be assigned to the account. He should keep in mind what he wants his advertising to accomplish, and appraise each agency according to whether it appears to possess the talents required for meeting these goals. And it is certainly wise to consider each agency's record in serving other accounts, especially those with similar advertising problems.

**Table 19.1**  
**Evaluation and Selection of Advertising Agencies**

<i>Evaluation of a new agency includes the participation of the:</i>		<i>The responsibility for selection of a new agency rests with the:</i>	
Advertising directors in 89% of the companies		President in 35% of companies	
Presidents in	70%	Advertising directors in	30%
Sales managers in	54	Sales directors in	11
Executive vice-presidents in	48	Management committees in	8
Marketing directors in	43	Executive vice-presidents in	6
Sales-promotion managers in	29	Marketing directors in	5
Public relations directors in	18	Board chairman in	3
Product managers in	14	Public relations directors in	2

Source: *Printers' Ink*, June 10, 1960, p. 38.

As shown in Table 19.1, which summarizes some results of a survey of 400 executives in companies using advertising agencies, selection of an agency is a top-level decision. This study revealed that the decision on which agencies would be considered for selection—i.e., evaluated—was made by the top advertising executive in 63 per cent of the companies, the president in 23 per cent, and other executives or several jointly in 14 per cent. In most companies, several executives participated in the actual evaluation. But the *final* agency-selection usually was made by an individual—most often the president, and next most often the highest advertising executive. More than a third of the respondents indicated that they re-evaluated their present agency's services "constantly," "continually," or "every day," and 44 per cent said that their companies conducted annual formal reviews of the agency's contribution to the total marketing effort.<sup>23</sup> Consequently, agencies are always sensitive to signs

<sup>23</sup> "How Agencies Find New Business," *Printers' Ink*, June 10, 1960, pp. 35 and 36.

of an advertiser's dissatisfaction with its present agency's performance. Advertisers switch agencies frequently, and this serves as a brake on the inclination of some agencies to overspend their client's funds. Furthermore, it provides additional stimulus for agencies to make advertising programs as effective as possible.

#### DETERMINING THE ADVERTISING APPROPRIATION

The size of the advertising appropriation should be based on advertising effectiveness—i.e., on what advertising will produce in terms of added sales and net profit dollars. But there are many factors affecting sales and profits besides advertising. Some of these non-advertising factors are price, middlemen's activities, competitors' activities, the "push" salesmen put behind the product, and the quirks of consumers' buying habits and patterns. So many factors influence sales and profits that it is difficult to isolate advertising's effect, and, hence, to determine the size of the advertising appropriation. Yet, in any rational approach to advertising decision-making, advertising effectiveness must be related to the size of the appropriation.

There is a difference between the way advertisers *should determine* their appropriation, and the way most of them actually *do*. The majority, mainly because of difficulties encountered in isolating the effect of advertising, rely on intuitive methods in deciding on the appropriation. We will consider some of these methods later in the chapter. First, however, let us consider the best method—the one advertisers should use. Having examined the best method, the reader should be better prepared to evaluate more generally used methods.

#### *Incremental Approach*

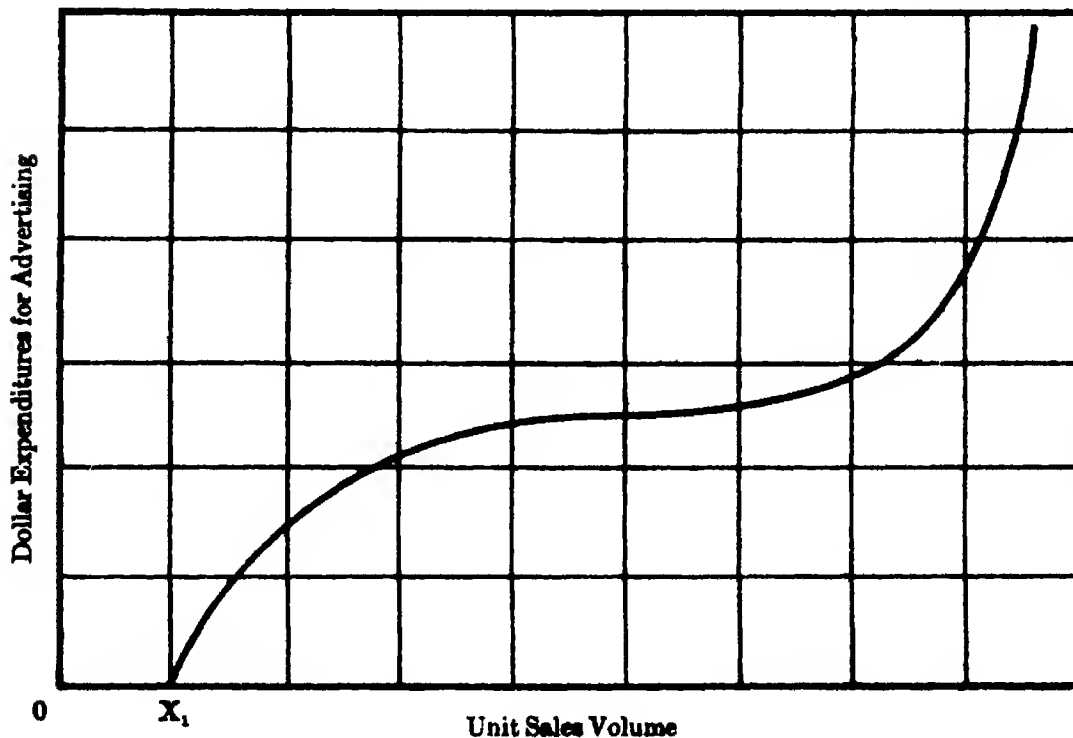
The incremental approach to determining the size of the advertising appropriation is derived from the analytical tool economists call *marginal analysis*. This approach puts the problem of determining the appropriation into the proper conceptual framework since, logically, the advertiser should set the appropriation at that amount which maximizes the net profit contribution of advertising. In arriving at this amount, it is necessary first to examine the relationship of advertising—as a cause—and sales, as the effect.

**EFFECT OF ADVERTISING ON UNIT SALES VOLUME.** Chart 19.1 depicts the relationship of advertising to unit sales volume as marketing theoreticians suggest it exists.<sup>24</sup> Some sales would be made, even without any

<sup>24</sup> See, for example: S. Hollander, Jr., "A Rationale for Advertising Expenditures," *Harvard Business Review*, Vol. 27, No. 1 (January, 1949), pp. 79-87.

expenditure for advertising, and this is illustrated at point  $X_1$  on the chart. As advertising expenditure is begun, and as increments of expenditure are added, unit sales volume first expands rather slowly, and then more rapidly; finally, additional advertising expenditure has less and less effect. This indicates that there must be a minimum size appropriation beneath which expenditures for advertising are inordinately costly in terms of the resulting sales. It also indicates that beyond a certain point, increases in the advertising appropriation are accompanied by diminishing returns in terms of unit sales volume.

Chart 19.1



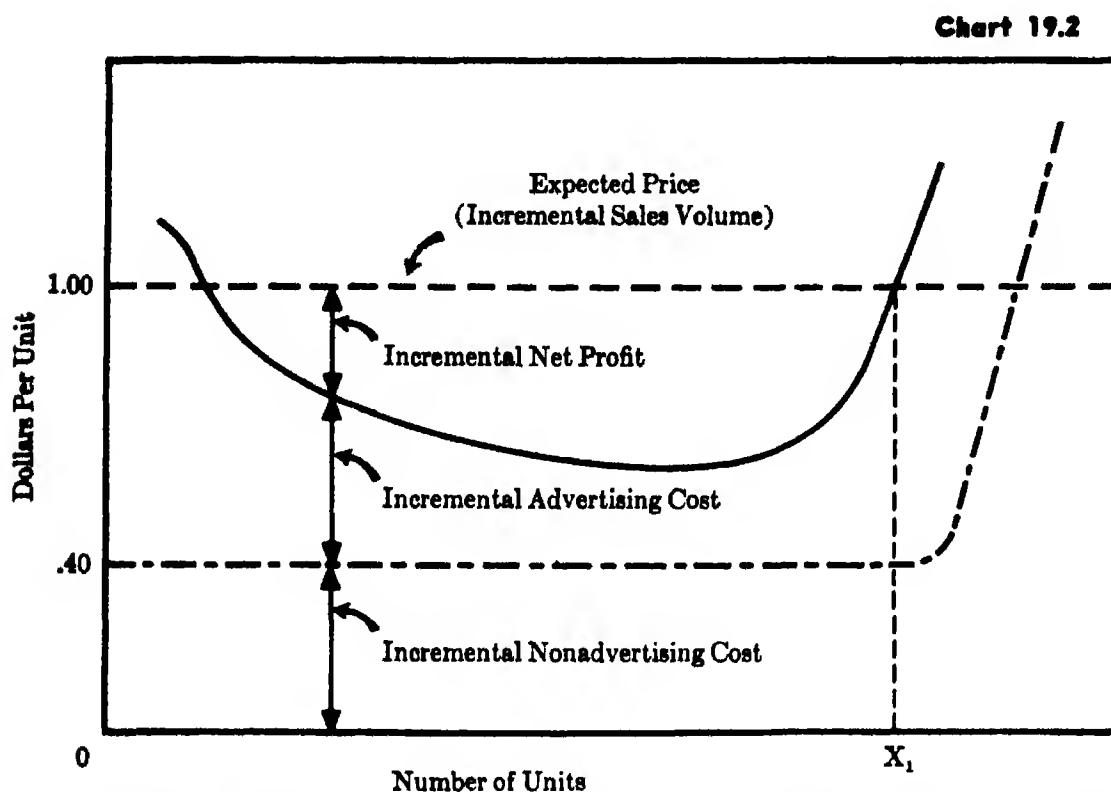
Source: Adapted from: S. Hollander, Jr., "A Rationale for Advertising Expenditure," *Harvard Business Review*, Vol. 27, No. 1 (January 1949), pp. 79-87.

The graphic relationships shown in Chart 19.2 shed additional light on the incremental approach. Two important assumptions are built into this schematic representation. The first is that price remains constant over a practical range of sales volume. The modifying term "practical" reflects the fact that there are upper limits to increases in sales volume because of factors such as capacity to consume and buying power. The second is that non-advertising cost (all variable costs other than advertising including those of production, physical distribution, and personal selling) remains constant over this range of sales (40¢ per unit in this illustration). This means, then, that the only quantities which change in this



range of sales are incremental net profit and incremental advertising cost.

In Chart 19.2, examine the portion of the incremental advertising cost curve where incremental advertising costs are rising (the curve slants upward). If there is to be any advertising at all, it should be expanded up to the point of diminishing returns. This point is represented on this chart by the intersection of the advertising cost function and the incremental sales revenue line, and it lies at  $X_1$ , where the combined in-



Source: Adapted from: J. Dean, *Managerial Economics* (Englewood Cliffs, N.J. Prentice-Hall, 1951), p. 356.

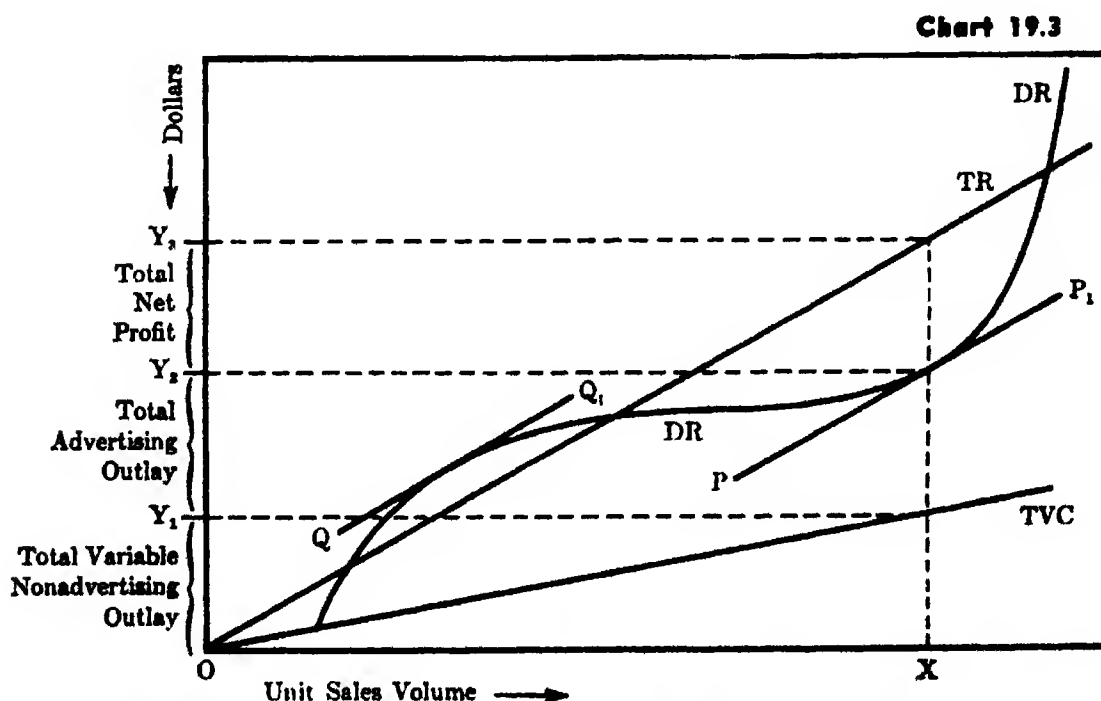
cremental advertising and nonadvertising costs intersect with the price line. Up to this point it is profitable to increase advertising outlay. If incremental nonadvertising cost is 40¢ per unit, and price is \$1 per unit, we can continue to add to advertising cost as long as these costs do not exceed 60¢ per unit. When more than 60¢ per unit is invested in advertising, the additional business it brings in is unprofitable and not worth getting.

Dean explains the rationale for the upward sweep in the advertising cost curve in these words:<sup>25</sup>

<sup>25</sup> J. Dean, "How Much to Spend on Advertising." *Harvard Business Review*, Vol. 29, No. 1 (January 1951), p. 66.

The upward turn in the curve reflects primarily the tapping of successively poorer prospects as the advertising effort is intensified. Presumably the most susceptible prospects are picked off first, and progressively stiffer resistance is encountered from layers of prospects who are more skeptical, more stodgy about their present spending patterns, or more attached to rival sellers. The rise may also be caused by progressive exhaustion of the most vulnerable geographic areas or the most efficient advertising media. Promotional channels that are ideally adapted to the scale and market of the firm are used first. (Actually, for firms with expansible markets, the advertising cost curve may have several minimum points corresponding to most efficient use of different media appropriate for different-size markets, e.g., newspapers, billboards, magazines, radio.)

Chart 19.3 shows how the optimum appropriation should be obtained, if the seller knows the nature of the advertising-to-sales relationship and makes the same assumptions as before. Thus, there is still the assumption that price remains constant, which means that total sales revenue (TR) varies at a constant rate with changes in sales volume. Also retained is the assumption that total variable non-advertising costs (TVC) vary at a constant rate. In order to determine the advertising appropriation which maximizes net profit, one must find the point on the advertising-sales curve (DR) where a tangent can be drawn parallel to the total sales revenue curve (TR). One such line is  $QQ_1$ , but this point of tangency obviously represents a condition where total costs are greater than total revenues. The tangent line the decision-maker should be in-



Source: Adapted from: J. Howard, *Marketing Management: Analysis and Planning*, rev. ed. (Homewood, Ill.: Richard D. Irwin, 1963), p. 407.

terested in is  $PP_1$ , for the point of tangency here is also the profit-maximizing point. On the vertical axis, the optimum outlay for advertising is represented by the distance  $Y_1Y_2$ , total variable non-advertising outlay by  $OY_1$ , and total net profit by  $Y_2Y_3$ .

#### *Measuring Effectiveness of Advertising*

The reason why the conceptually correct incremental approach is not widely used traces directly to the fact that few companies have been successful in isolating and measuring the effect of advertising on sales. In fact, most companies devote very little research effort toward the development of means for improving advertising effectiveness. One authority estimates that "probably no more than 1/5 of 1% of total advertising expenditure is used to achieve an enduring understanding of how to spend the other 99.8%."<sup>26</sup> Gloomy as this estimate appears, there are companies which do inquire into the advertising-to-sales relation.

E. I. du Pont has an operations research team working toward the goal of measuring the exact effect of advertising on sales and profits. Eventually, this team hopes to determine just when and how advertising pays in terms of profits, and to find a yardstick for use in setting advertising appropriations on different products so that maximum profits result.<sup>27</sup> As part of the du Pont research effort, experiments are being conducted in allocating various dollar amounts of advertising to different industrial markets with the intention of determining the effects on sales of different dosages of advertising.<sup>28</sup>

At a much smaller company, Noreen, Incorporated, which markets a color hair rinse for women, consultants conducted a series of controlled experiments designed to measure sales response to advertising. From an organization standpoint, this company was small and closely-knit enough to effectively control the impact on sales of such factors as point-of-purchase promotion, and salesmen's performance. Further, as it subscribed to the services of A. C. Nielsen Company (an independent marketing research organization) it had a usable measure of competitors' sales at the retail level. Thus, Noreen was in a position to allow national and local advertising to fluctuate considerably, while other sales-influencing variables were held nearly constant, thus allowing the measurement of the sales results of different advertising programs and different amounts of advertising. Multiple correlation techniques were employed in analyzing the data obtained, and the researchers succeeded in constructing a mathematical model of sales response to advertising.<sup>29</sup>

<sup>26</sup> J. W. Forrester, "Advertising: A Problem in Industrial Dynamics," *Harvard Business Review*, Vol. 37, No. 2 (March-April 1959), p. 102.

<sup>27</sup> "A Profit Yardstick for Advertising," *Business Week*, November 22, 1958, p. 49.

<sup>28</sup> "New Need to Prove Ads Sell," *Printers' Ink*, February 24, 1961, p. 25.

<sup>29</sup> E. B. Slade and J. R. Roseboom, "Measuring Advertising Effectiveness," *Western Business Review*, Vol. 2, No. 4 (November 1958), pp. 16-26.

The operations research group at Arthur D. Little, Inc. (a consulting firm specializing in providing management advice and analysis for client companies) has contributed three concepts of great potential usefulness in the analysis of advertising's effect on sales: the sales decay constant, the saturation level, and the response constant. These three concepts are defined as follows:<sup>30</sup>

*Sales Decay Constant.* In the absence of promotion, sales tend to decrease because of product obsolescence, competing advertising, etc. Under relatively constant market conditions, the rate of decrease is, in general, constant: that is, a constant per cent of sales is lost each year.

*Saturation Level.* Defined as the practical limit of sales that can be generated. It depends not only on the product being promoted, but also on the advertising medium used; it represents the fraction of the market that the particular campaign can capture. This saturation level can often be raised further by other advertising media.

*Response Constant.* Defined as the sales generated per advertising dollar, when sales are at a level  $S$ . For instance, where  $M$  is the saturation level and  $r$  the response constant, the following relationship, in general, holds:

$$\text{Sales generated per advertising dollar} = \frac{r(M - S)}{M}$$

The Arthur D. Little organization provides a simple mathematical description of the interaction of these factors:

$$\frac{dS}{dt} = rA \frac{M - S}{M} - LS$$

where:  $dS$  is the increment of sales  
 $dt$  is the increment of time  
 $L$  is the sales decay constant  
 $M$  is the saturation level  
 $r$  is the response constant  
 $A$  is the rate of advertising expenditure  
 $S$  is the volume of sales.

In the formula,  $r$  multiplied by  $A$  represents the intensity of advertising effort for a given level of advertising expenditure,  $M - S$  divided by  $M$  represents potential market, and  $L$  multiplied by  $S$  indicates decay losses. Thus, this equation states that the increase in the rate of sales  $\frac{(dS)}{(dt)}$  is proportional to the intensity of the advertising effort ( $rA$ ) which reaches the market  $\left(\frac{M - S}{M}\right)$  with a deduction for decay losses ( $LS$ ).<sup>31</sup>

<sup>30</sup> M. L. Vidale and H. B. Wolfe, "An Operations-Research Study of Sales Response to Advertising," *Operations Research*, Vol. 5, No. 3 (June 1957), pp. 372, 375-376.

<sup>31</sup> M. Vidale, J. Voss, and H. Wolfe, "Experimental Research in Advertising," in D. W. Ewing (Ed.), *Effective Marketing Action* (New York: Harper & Brothers, 1958), p. 151.

This equation may also be used to calculate the advertising effort needed to maintain sales at a steady predetermined level. For this purpose, the increase in the rate of sales  $\frac{(dS)}{(dt)}$  is set at zero (i.e., no increase in the sales rate) and the equation is manipulated algebraically to yield:

$$A = \left( \frac{L}{r} \right) \frac{SM}{M - S}$$

**OTHER "MEASURES" OF ADVERTISING EFFECTIVENESS.** Most measures of advertising effectiveness in current use are more superficial than real. These include such "measures" as size of audience, program ratings, advertisements noted and remembered by the reader or audience, and numbers of inquiries received. Although such measures may be useful in determining the extent to which the advertiser's message is reaching the market, they do not serve as "real" measures of advertising *success*, which can only be measured in terms of added sales and profits. No superficial measure of advertising effectiveness can possibly substitute for the real measures—sales and net profits.

#### *Per-Cent-of-Sales Approach*

The per-cent-of-sales approach to determining the advertising appropriation is a traditional method that is still widely used. In this method some arbitrary percentage is applied to past sales figures, forecasted sales, or some combination of past and future sales and, supposedly, up comes the advertising appropriation. This simplicity, indeed, is about the only thing good that can be said about the percentage approach, for it is difficult to defend it on rational grounds. One reason is that it assumes that the advertising cost per unit of product remains constant, regardless of the sales volume. This is a mistaken notion for, as shown in Charts 19.1 and 19.3, it would be most unusual for a company's sales to have a straight-line relationship with advertising. An even more important shortcoming of the percentage approach is that it assumes that advertising follows sales. Advertising should result in sales and not the other way around. Of course, if the percentage is applied to forecasted sales, the assumption now *appears* to be that advertising precedes sales. But even this cannot be defended logically, for the size of the appropriation affects the size of the possible sales volume. Still another criticism of this approach relates to the percentage figure to apply to sales. Where does it come from? The answer is that in most cases, it can only come from records of past sales volumes and advertising expenditures. There is no assurance that percentage relationships that held in the past will continue to hold in the future.

### ***Objective-and-Task Method***

The objective-and-task method for determining the advertising appropriation consists of three steps: (1) objectives are defined in terms of desired sales volumes, net profits, share of the market, and the like; (2) the amount of advertising space and time needed to achieve these objectives is estimated; (3) this amount of advertising is expressed in dollar terms in order to arrive at the size of the appropriation. This method is logical in that it treats advertising as a cause of sales rather than an effect. Advertising is considered strictly as a device for producing sales, net profit, market share, and the like. If the objective-and-task method is used with the intention of maximizing the net profit contribution of advertising, i.e., if the main objective is to maximize net profits, then, of course, this is equivalent to using the incremental approach. Unfortunately, most companies using this method appear to concentrate more on the effect of advertising on sales than on net profit. Without this profit maximization emphasis this method might very well produce an advertising appropriation that increased costs more than it increased profits.

### ***Other Approaches***

Three other common approaches to determining the advertising appropriation should be mentioned. The first is known as the arbitrary method, in which the appropriation is decided either "by pure guess" or "by allotting all the advertiser can afford." The second is called "matching competitors' expenditures"; the advertiser, in effect, permits his competitors to establish his appropriation. The third is the "tax per unit of product" in which a fixed sum is put in the "advertising pot" for each unit of the product sold or expected to be sold. Each of these three methods may be objected to on logical grounds. We leave it to the reader to do so.<sup>32</sup>

### **SELECTION OF ADVERTISING MEDIA**

Most of the advertising appropriation is used for purchasing space and time in different media. These media include newspapers, magazines, television, radio, outdoor posters, transportation cards, direct mail, and point-of-purchase displays. Even though media selection is usually left to the agency, advertisers should know enough to be able to evaluate the effectiveness of the agency's selections.

<sup>32</sup> The reader interested in additional analysis of methods for determining the advertising appropriation should consult: A. W. Frey, *How Many Dollars for Advertising* (New York: Ronald Press, 1955).

As Table 19.2 shows, different advertisers follow quite different plans in allocating their appropriations to media. Through considering the expenditure patterns of even this small sample of advertisers, we can learn a good deal about media strategy. With this end in view, the reader should think through such questions as these: Why should American Chicle spend their entire appropriation on TV, while Wm. Wrigley, Jr., another chewing gum manufacturer, divides its expenditures fairly evenly among printed media, TV, and billboards? This might be partly explained by the difference in the size of their advertising appropriations. A certain minimum amount of advertising is necessary to have an effect in any medium, so the smaller advertiser must necessarily concentrate his message in fewer media. Why should Sherwin-Williams concentrate so heavily on magazines? This company is seeking to reach only a limited segment of the market, property owners, and magazines offer a particularly good opportunity for selective coverage. In addition, magazines allow the use of color, an important factor in advertising paint. Other factors affecting media selection are revealed through examination of Table 19.2. For example, the heaviest users of television are the producers of consumer goods consumed by mass markets, such as chewing gum, cosmetics, and soap products, since TV has a very broad audience. Business papers are used almost exclusively by manufacturers with important industrial markets. Newspapers are used where more selective regional coverage is desired than is offered by national magazines. In the final analysis, media selection also reflects differing opinions with respect to the appeal and effectiveness of each medium for particular products.

Analysis of such questions as these should reveal the main factors affecting media selection. Of course, the nature of the market which the advertiser desires to reach and the type of product being advertised are the most fundamental. Also important are the distinctive characteristics associated with specific media. For instance, the fact that newspapers are issued daily causes some advertisers to use them and others to avoid them. The size of the appropriation is a highly important factor; small budgets usually mean that expenditures should be concentrated in a few media for best results, whereas large appropriations ordinarily have to be spread over many media to avoid a premature onset of diminishing returns. Ideally, circulation (general exposure) of the media used should be confined to the geographical areas where the advertiser has distribution. Many other considerations, both qualitative and quantitative, affect media selection. One authority lists the following as rational determinants of media selection: the product itself; the budget; competitive activity; frequency versus coverage; continuity; impact on distribution; flexibility

**Table 19.2**  
**Twenty "Million Dollar Plus" Advertisers of 1959**  
**Total Dollar Expenditures and Percentages Allocated to Five Major Media**

Advertiser	Total	Percentage of Total Expenditure in:				
		Consumer Magazines	Newspapers	Television	Business Papers	Outdoor
Allied Chemical	\$ 3,366,164	23.95%		4.88%	61.64%	3.33%
American Chicle	5,828,120			100.00		
Avon Products	4,451,635	16.41		82.60		
Beam Distilling	1,164,471	21.52	62.48%			
Bristol-Myers	28,377,706	16.32	4.73	71.75	0.05	16.00
Carrier Corp.	1,214,898	27.06	23.55		49.39	
Caterpillar Tractor	2,338,412	39.30			54.37	
Coca-Cola Company	11,856,521	35.97	10.10	33.26	0.61	20.06
Derby Foods	1,886,115		100.00			
E. I. duPont de Nemours	15,761,575	35.31	11.46	32.77	16.73	1.88
Eastman Kodak Co.	14,461,387	35.10	13.59	39.88	11.41	
General Electric	31,666,263	40.75	23.97	20.95	12.82	1.05
General Motors	110,602,039	26.60	34.92	21.52	2.87	8.89
Kellogg Company	21,766,988	12.63	18.04	61.76	0.55	6.31
Procter and Gamble	105,616,190	3.38	5.92	90.26	0.44	
Richfield Oil	1,930,199	6.90	14.29	22.75		56.00
Sherwin-Williams	1,503,605	72.37	17.66		4.81	
Sunkist Growers	2,273,706	42.41	46.09	5.66	5.78	
United Fruit Co.	1,243,582	68.01		31.90		
Wm. Wrigley, Jr.	7,794,626	9.14	18.53	35.27		30.64

Source: Calculated from data in "Advertisers' Guide to Marketing for 1961," *Printers' Ink*, Sec. 2, September 9, 1960, pp. 345-370.



in timing of purchase and in permitting changes in message and spending pattern, both dollar-wise and geographically; franchise position—that is, special position or sponsorship associations; appropriateness of media for product and message; cost per thousand readers or viewers; effectiveness of selling message; circulation of media among desired prospects and customers.<sup>33</sup>

From a conceptual standpoint, media selection is a problem in determining optimum allocation of the advertising appropriation. The total should be so divided among the different media—newspapers, magazines, television, outdoor posters, etc.—that the marginal returns from each type of media are all equal. In other words, the last dollar, invested in newspaper advertising should produce the same dollar return as the last dollars invested in each of the other media. Practically speaking, the procedure for obtaining this optimum allocation consists of three steps: (1) the gathering—by type of media—of accurate data on past expenditures, (2) analysis of these data together with data on sales results to obtain reasonably accurate representations of the net returns curves for each type of media, and (3) successively adjusting the allocation of the appropriation to different media so that the slopes of the several net returns curves tend to equalize.<sup>34</sup> This last step is a “try, try again” approach—starting with a given feasible allocation, testing to discover profitable changes, and making changes that will raise net returns. When no further profitable changes can be made, we have the optimum allocation of funds. This method is similar to the repeated trial approach used in linear programming. In fact, this process may be described as non-linear programming.

#### *Cost Comparisons of Media in the Same Classification*

The matter of cost may become a crucial selection factor particularly when the advertiser, or agency media man, is attempting to decide among media in the same media classification—for instance, between two newspapers. In situations of this sort, each newspaper typically has a different size of circulation and different advertising rates. The technique of comparison is to convert circulation and rate figures to a common basis. Newspapers normally quote their rates by the agate line, of which there are 14 in a space one column wide and one inch deep. Therefore, the yardstick used in making cost comparisons of newspapers is known

<sup>33</sup> L. Adler, “How Marketing Management Can Make Sounder Media Decisions,” in W. Dolva (Ed.), *Marketing Keys to Profits in the 1960's* (Chicago: American Marketing Association, 1960), p. 155.

<sup>34</sup> F. V. Waugh, “Needed Research on the Effectiveness of Farm Products Promotions,” in L. H. Stockman (Ed.), *Advancing Marketing Efficiency* (Chicago: American Marketing Association, 1959), p. 213.

as the milline rate—the cost of reaching one million readers with one agate line of advertising. The milline rate is calculated as follows:

$$\text{Milline Rate} = \frac{\text{Agate Line Rate} \times 1,000,000}{\text{Circulation of Newspaper}}$$

Magazines are normally compared according to the cost of reaching one thousand readers with a given amount of advertising space. For instance, the cost of using a full page of magazine space is calculated as below:

$$\text{Cost per 1,000} = \frac{\text{Page rate} \times 1,000}{\text{Circulation of Magazine}}$$

Cost comparisons of media in the same classifications follow similar patterns for radio, television, outdoor posters, and car cards. Usually, the rate for using a given amount of space is multiplied by 1,000 and divided by the circulation (or audience) of the medium being compared. This results in a cost-per-thousand figure similar to those used for comparing magazines.

The rational decision-maker should use such cost comparisons with great caution. He should know what is actually being compared—the costs of achieving a certain circulation with a given amount of space or time. Circulation obviously refers to the number of copies of a publication distributed or the medium's claim as to its size of audience. Circulation is not readership. This method of comparison, furthermore, takes no account of the relative power of different media to influence their readers or listeners. Cost comparisons such as this should never be used as the sole basis for media selection. They should see limited use, and then only after consideration of the more basic factors discussed earlier.

### COOPERATIVE ADVERTISING

Sometimes, the decision-maker has occasion to consider whether or not his firm should participate in a cooperative advertising program. There are two kinds of cooperative advertising: horizontal and vertical.

Horizontal cooperative advertising is advertising jointly sponsored by firms on the same distribution level—e.g., manufacturers, growers, farmers, or retailers. Generally, such advertising is intended to stimulate primary demand for a generic product and, often, very high percentages of total industry members participate. Whether a given company should participate depends on such factors as the significance of competition from products of other industries, comparative effectiveness of selective demand advertising, possibilities of expanding primary demand, and the company's "normal" share-of-the-market percentage.

Vertical cooperative advertising is illustrated by the manufacturer who shares certain advertising costs with his retailers according to some

pre-arranged plan.<sup>35</sup> One study showed that 63 of the 100 largest national advertisers engage in vertical cooperative advertising.<sup>36</sup> Quite often, manufacturers use vertical cooperative advertising to stimulate retailers to put more "push" behind the product. They may also use it: to expand the amount of advertising a dollar buys (by getting dealers to pay part of the costs); to get dealers to stock the product by offering a cooperative advertising arrangement as "bait" to secure local advertising media rates (which are usually lower than rates charged national advertisers); to encourage retailers to advertise in order to identify local outlets where consumers can find the product; and to provide local advertising support for national advertising campaigns.

<sup>35</sup> Manufacturers using vertical cooperative advertising are subject to certain restrictions imposed by the Robinson-Patman Act. See Chapter 10.

<sup>36</sup> "Cooperative Advertising," *Printers' Ink*, May 13, 1960, p. 28.

### CONCLUSION

In this chapter, our emphasis has been on the management of advertising effort and the making of advertising decisions. Starting with the premise that advertising's ultimate objective is to increase the firm's net profits, we have analyzed five different decision situations, the most basic of which relates to whether a firm should advertise at all. Making this decision requires a thorough review and appraisal of the entire marketing situation. Firms which decide to advertise must also make decisions with regard to the selection and use of advertising agencies. Further important decisions are required concerning the advertising appropriation, and among the requisites for rational decision-making here is the important matter of measuring advertising effectiveness in terms of sales and net profits. Additional decisions discussed were those involving the selection of advertising media and participation in cooperative advertising. These are by no means the only decisions which need to be made in advertising management, but they are certainly the ones of greatest concern to the marketing manager.

### QUESTIONS AND PROBLEMS

1. Explain the meaning of the following terms:
 

a. generic product	e. saturation level
b. brand differentiation	f. response constant
c. advertising agency	g. milline rate
d. sales decay constant	h. advertising media
2. Explain and contrast the terms in each of the following pairs:
  - a. primary demand and selective demand

- b. demand elasticity and demand expansibility
  - c. horizontal cooperative advertising and vertical cooperative advertising
3. Analyze the relationships that the different short-term objectives of advertising should bear to the long-term goals of marketing management.
  4. What is an "advertising opportunity?" How can advertising opportunities be detected?
  5. Under what conditions are consumers likely to be willing to pay more for an advertised product than for an unadvertised product? Using your own shopping experience as a guide, provide some examples of instances where you paid more for an advertised product when competing unadvertised products were available?
  6. Currently, a certain manufacturer sells 5,000 units of his product in a given marketing area each year. The product is distributed through retailers and the manufacturer has not used local advertising in this particular area for several years. Retailers pay the manufacturer \$20 per unit of the product and price it at \$25. The manufacturer estimates his total costs per unit at \$17.50. This manufacturer now wants to launch a local advertising campaign in the marketing area and estimates that the cost of an adequate campaign would amount to \$20,000. How much additional sales volume should this advertising campaign produce in order for the manufacturer to break-even on the cost?
  7. How does a company's financial condition affect management's decision to use advertising for the purpose of producing immediate sales? For the purpose of producing deferred sales? What arguments might a management use in an attempt to secure a bank loan for purposes of carrying on an advertising campaign?
  8. How are advertising decisions affected by each of the following:
    - a. company policy on distribution intensity
    - b. channels of distribution for the product
    - c. competitors' advertising practices
    - d. replacement rate and consumption time for the product
    - e. price of the product
  9. If you were the marketing manager of a large manufacturing company which had an advertising budget of millions of dollars, would you favor or oppose the commission system of

- compensating advertising agencies? Why? Would you take the same position if you were the president of a large advertising agency? Why? If you were the owner of a large city newspaper, what would be your position on this question? Why?
10. Under what circumstances would you advise a manufacturer to switch advertising agencies? Under what circumstances might an advertising agency voluntarily "resign" a manufacturer's account?
  11. "The size of the advertising appropriation should be based on advertising effectiveness." Bearing this "should be" statement in mind, how might you, as the manager of a marketing research department, contribute to the decision on size of the advertising appropriation?
  12. Compare and contrast the following approaches to determining the size of the advertising appropriation:
    - a. incremental
    - b. per-cent-of-sales
    - c. objective-and-task
    - d. arbitrary
    - e. matching competitors' expenditures
    - f. tax per unit of product
  13. To what extent should the sales forecast be considered in determining the size of the advertising appropriation? In selecting media?
  14. Select five full-page advertisements from a recent issue of *Life* or *Look*, and list the main factors that probably caused each advertiser to select this particular medium.
  15. "Everyone connected with advertising—the advertiser, the agency, and the media—has a sincere interest in finding out whether advertising is successful." Agree or disagree? Why?
  16. Comment on the following two statements:
    - a. "Advertising's job, purely and simply, is to communicate, to a defined audience, information and a frame-of-mind that stimulates action. Advertising succeeds or fails depending on how well it communicates the desired information and attitudes to the right people at the right time at the right cost."
    - b. "The average consumer is subjected to roughly 1,600 advertising impressions per day. As a result, he is developing an imperviousness to advertising in general and an increasing ability to shut off advertisers' messages."

17. From time to time, certain politicians suggest that a tax should be placed on advertising, not only to raise revenue but to protect consumers from "further commercial invasions of their homes." As a marketing executive, what position would you take with regard to this proposal? As the "target" of advertisers' messages, what is your attitude? Justify the positions you take.
18. In a certain city there are two large newspapers—a morning and an evening paper—both of which reach similar audiences and have the same circulation areas. Advertising rates per column inch are: \$7.00 in the morning paper and \$10.50 in the evening paper. The morning paper has a circulation of 200,000, and the evening paper has a circulation of 250,000. Calculate and compare the milline rates of these two papers. Under what conditions might an advertiser use the paper with the higher milline rate?
19. A book publisher wants to insert a page of advertising in one of two monthly magazines, both of which are directed primarily to male audiences. The first magazine has a page rate of \$6,500 and a circulation of 875,000, while the second has a page rate of \$7,100 and a circulation of 1,140,000. Assuming that the audiences of both magazines are roughly comparable (i.e., from the standpoints of age, income, geographical location, etc.), which is the better buy? Under what conditions might the publisher decide to use the other magazine?
20. Western Pretzel Works, Inc., has retained an advertising agency to handle its advertising for the forthcoming year. Media expenditures are anticipated as follows:

	<u>Card Rate</u>	<u>Media Commission</u>
Consumer Magazines	\$100,000	15%
Dealer Magazines	24,000	10
Newspapers	46,000	15
Outdoor Posters	6,000	16 $\frac{2}{3}$
Television	43,000	15
<b>Total</b>	<b>\$219,000</b>	

Costs of art work, typography, etc. are estimated at \$2,250, and the agency will bill the company for these items at cost plus 15 per cent. Western Pretzel has a long standing policy of taking all cash discounts and plans on paying in-

voices received from the agency within the cash discount period. The discount will amount to 2 per cent of the net costs of space and time.

Assuming that the agency is to be compensated on the commission basis, what is:

- a. the total amount Western Pretzel will pay the agency?
- b. the total amount the agency will pay to all media and services?
- c. the total amount the agency will receive as compensation?

21. Newton Packing Company is a medium-sized meat packer located in eastern Washington. For several years, annual sales have been approximately \$5 million. Newton handles its own wholesaling of the fresh and smoked meat and meat products it processes. In addition, the company wholesales the products of other manufacturers not engaged in direct distribution in the territories covered by Newton. The company sells its products to independent retail meat markets and meat departments, to large chain grocery organizations, and to certain high-class restaurants and hotels. Newton salesmen cover territories in Washington, Oregon, Idaho, Montana, and northern California.

In the past, this company did not use an advertising agency, but recently arrangements have been made for a small Seattle agency to handle the company's account. The Newton advertising manager working in cooperation with the account executive has proposed the following advertising budget for the coming year:

Costs of artwork, typography, etc., and all overhead expenses	\$16,000
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Media Costs:

Magazines	\$42,000	
TV spot announcements	7,000	
Dealer cooperative advertising	14,000	
Dealer display materials	20,000	83,000

Reserve for Contingencies	1,000
	<hr/> \$100,000

- a. As president of Newton Packing Company, what questions might you ask the advertising manager about this

proposed budget? What further information might you ask for?

- b. What further refinements in the method of presenting this budget should be made?
- c. What method was used to determine the size of this advertising appropriation? What should be the relationship between past sales history, anticipated future sales, and the advertising budget?



M A N A G E M E N T

O F

P E R S O N A L

S E L L I N G

# 20

If a marketing program is to have maximum impact, there must be close coordination of advertising and personal selling efforts, both in their planning and implementation. A good part of advertising effort may be wasted if personal selling effort is not directed and applied in ways that will capitalize on the interest aroused by the advertising. Similarly, personal selling effort is wasted in explaining details (about the product to customers and prospects) more economically explained through advertising.

Determining the proper "mix" of advertising, personal selling, and other forms of promotional effort is one of the

fundamental problems of marketing management. If management decides to rely mainly on personal selling, advertising may be used primarily as a means of making salesmen's calls more effective. For example, advertising may be used to make dealers more receptive to the sales presentation, or to convey part of the selling message, thus saving much of the salesman's time. In some situations, advertising may take care of the need for contact with smaller accounts, thus making it possible for the salesmen to concentrate on the larger and generally more profitable accounts. The opposite situation exists when management decides to rely mainly on advertising: here, advertising does the pre-selling and order-taking becomes the salesmen's chief function. But the general rule still holds: if management has made a rational decision on the marketing mix, the last advertising dollar should bring in results identical to the last personal selling dollar.

There are both differences and similarities between the management of personal selling and the management of advertising: unlike advertising, a manufacturer must ordinarily assemble his own pool of selling talent, develop its skills, and direct it in his effort to maximize profits. It is, of course, possible for a manufacturer to shift the entire personal selling responsibility to middlemen, but this is not as common a practice as the shifting of advertising responsibilities to an agency. Like advertising, there are problems in determining the kind of selling force needed, its size, the method of compensating salesmen, the amount of the personal selling appropriation, and the best ways of allocating personal selling effort among customers and prospects. There is also the problem of appraising personal selling effectiveness. We will consider all of these in the following discussion.

#### DETERMINATION OF KIND OF SELLING FORCE NEEDED

The kind of sales force that is best for a particular manufacturer depends on many factors, but especially on the marketing mix or the marketing strategy. The marketing mix or the marketing strategy, in turn, depends on such basic things as the nature of the product line and the sort of markets the manufacturer desires to cultivate. All salesmen in some situations must aggressively seek orders and in other situations need only take orders that come to them, but the degree of emphasis on order-taking and order-getting varies with different selling jobs. The driver-salesman for a soft drink bottling company is primarily an order-taker, since his product has already been strongly pre-sold to the consumer, and the retailer reorders automatically for stock. The salesman calling on householders to sell encyclopedias is much more of an order-getter, since he has the primary responsibility for creating demand. If advertising is the predominant element in the marketing mix, distribution channels are likely to

be indirect, and the manufacturer's salesmen are apt to be order-takers primarily and order-getters only incidentally. The opposite situation exists when advertising backs up personal selling in the marketing mix; distribution channels are normally more direct, and salesmen must concentrate more on selling since they cannot merely take customers' orders. Depending on the nature of the marketing mix, salesmen may be either active or passive forces in achieving sales through contact with customers and prospects.

**THE MISSIONARY SALESMAN.** The missionary salesman is only indirectly concerned with order-taking and order-getting, since the order is an indirect result of his primary public relations and promotional responsibilities with middlemen. Found only in consumer goods marketing, missionary salesmen work closely with dealers and distributors, performing such duties as checking middlemen's stocks, training wholesale and retail sales personnel, handling product demonstrations in retail outlets, briefing middlemen on the manufacturer's advertising program and impending new products, and assisting middlemen with other activities which enable them to do a more effective selling job for the manufacturer. In some fields (e.g., drugs and pharmaceuticals) the missionary is known as a "detail man" and makes calls on individuals who influence, though they do not make, purchase decisions (e.g., doctors, dentists, and hospital administrators).

**THE SALES ENGINEER.** The sales engineer is the industrial goods counterpart of the missionary salesman. Frequently, though not always, he has a technical background and formal education in engineering or some science. He performs functions similar to those of the consumer goods' missionary salesmen but he normally devotes more of his time to acquainting middlemen and industrial users with the technical characteristics of the products and with new applications of the products, and in helping them design installations or processes which incorporate the manufacturer's products. When an industrial goods manufacturer sells directly to users, and particularly when he seeks large orders to be manufactured to customers' specifications, the sales engineer will usually deal with a certain classification of account. In the electronics and missiles fields, for example, sales engineers are often used to concentrate exclusively on maintaining contact with military and government officials who either make or influence buying decisions.

It has been suggested that some companies could profitably break with tradition and specialize their salesmen in either of the two quite different tasks that make up the job of the field salesman—(1) retaining existing

customers and (2) converting non-customers into customers. The argument for this is that most companies should have some salesmen specializing in sales maintenance activities, and others in sales development. Two writers who favor this proposal sum up their position as follows: <sup>1</sup>

... there is a "Gresham's Law" of personal selling; when a salesman has a choice between routine sales maintenance activities and sales development activities requiring creativity, ingenuity, and resourcefulness, he will tend to give precedence to sales maintenance. Therefore, if sales development is to take place as a sustained and all-out effort, it is necessary to assign the task to salesmen who are prohibited from engaging in sales maintenance and are rewarded only for developing new accounts; in other words, to set up a specialized development task force within or auxiliary to the field sales department.

Specialization by task ... is a solution ... using to best advantage the talents and skills of every field salesman. Men who possess the qualities necessary for development work can be relieved of maintenance work which does not require full use of their rare and valuable capabilities. Similarly, salesmen who are effective in sales maintenance but lack the traits needed for new account development can be relieved of the need for "putting in" time and effort at the latter job. This time and this effort are largely wasted in such activity, but they can and would bring results in sales maintenance. ...

Furthermore, specialization should eliminate much of the very great waste which now typifies personal selling, by making possible more efficient utilization of manpower resources. In particular, it should eliminate the very high costs which are incurred when men with the gifts required for performance of the vital, difficult, and trying assignment of sales development are given responsibility for sales maintenance which they can do almost without half-trying, while other men who are not sufficiently gifted to develop markets but who can perform sales maintenance skillfully are, nevertheless, called on to work at development and are unhappy while doing it. ...

#### *Importance of the Job Description*

In every company, the job description, clearly outlining the duties and responsibilities of every selling job, lies at the heart of sales force management. The nature of sales positions varies from company to company for although salesmen in different companies have similar duties and responsibilities, the emphasis on specific tasks differs. This follows from the fact that no two companies have exactly the same marketing situations. Salesmen in particular companies develop certain skills, but when they move to different employers not all of these skills can be applied in the same ways or with the same emphasis. Salesmen's skills gained in the service of one employer, then, are transferable but the unique ways the

skills are applied are not. Thus, when an experienced electric typewriter salesman accepts a new job selling adding machines and calculators, his general understanding of the buying procedures and motivation of office management is transferable, but he must learn their reasons for use or nonuse of calculators and the comparative advantages of competitive models.

Effectiveness in managing the personal sales force depends considerably on the completeness and accuracy of the sales job descriptions. Through analysis of the duties and responsibilities making up the job, management derives the set of qualifications which salesmen should possess. This furnishes guidance in searching out the potentially most fruitful sources of recruits for the sales force and in selecting for employment those with the best qualifications. Comparison of the qualifications given in the job description with the qualifications of those newly hired indicates the needed breadth and depth of the initial sales training program. Similarly, comparing the job description with the qualifications possessed by the veteran salesmen is a basic technique of salesman evaluation and assists in determining the content of refresher sales training courses. Furthermore, the job description provides guidance for management in designing the sales compensation plan and in arriving at the best methods for supervising salesmen.

In some well-managed companies, the sales job description carries with it a statement of the performance standards management will use in appraising the salesman's effectiveness. For instance, if the job description reads "the salesman will maintain frequent contact with all his assigned accounts," there is a parallel statement such as "calls on Class A accounts are to be made no less than 26 times per year, calls on Class B accounts are to be at the rate of 13 times per year, and calls on all other accounts are to be restricted to no more than 6 per year." Each of the salesman's duties and responsibilities outlined in the job description has a parallel statement indicating management's definition of what constitutes good performance. Thus, salesmen are provided with a means to self-guidance and self-evaluation, and management's efficiency in supervising and controlling salesmen's activities is enhanced.

#### *Rate of Sales Force Turnover*

A widely-used measure of efficiency in sales force management is the rate of sales force turnover. It is defined as the number of salesmen separated, resigned, fired, etc. per 100 on the sales force. Thus, the formula for calculation is:

$$\text{Rate of Sales Force Turnover} = \frac{\text{Number of Separations}}{\text{Average Size of Sales Force}} \times 100$$

(Expressed as %)

Assume that a certain company has a sales force whose average strength is 200 men, and has 15 separations during a given year:

$$\frac{15}{200} \times 100 = 7.5\% \text{ Rate of Sales Force Turnover}$$

If this company has a 7.5 per cent rate of sales force turnover over a long period, the entire sales force is being replaced once every  $13\frac{1}{3}$  years ( $100\% \div 7.5\% = 13\frac{1}{3}$ ).

With increases in the rate of sales force turnover, costs of managing the sales force rise. According to one study, it costs (on the average) \$7,813 to search out, select, hire, and supervise a salesman until he begins to pay his own way.<sup>2</sup> This cost figure relates only to the directly traceable, out-of-pocket costs of turnover. It does not include such costs as those of lost business or loss of good will caused by mistakes made by inexperienced salesmen, or any of the other expenses associated with taking on sales personnel who do not succeed. Few companies have accounting systems refined enough to permit accurate quantitative measurement of the impact of salesman turnover on profit. However, a reasonable estimate of the actual total costs of salesman turnover for manufacturers may average at least \$10,000 per separation. Thus, sales force turnover in the example above could be costing the company at least \$150,000 each year.

Still, every sales force should have some turnover. When there is no turnover, the sales force may be growing stale, and inefficient salesmen may be staying on simply because management has failed to replace them. The sooner management identifies ineffective salesmen, the sooner they can be replaced by salesmen with greater productivity. Even in a sales force made up predominantly of effective people, there will still be some turnover since such people are prime candidates for promotion to managerial positions. Moreover, even the most successful systems of salesman recruitment and selection are far from perfect; and salesmen who will subsequently fail are bound to seep through even the most elaborate screening processes.

Management should also analyze sales force turnover periodically to determine the extent to which highly productive salesmen are leaving the company. When this is happening at an alarming rate, managerial ineffectiveness *may* be the cause. The average quality of the salesmen hired may be too high for the company, so that the job provides little challenge or opportunity for improvement to many of the salesmen after their initial period of training is completed. It is not worthwhile hiring such men since they are soon attracted away by more stimulating and rewarding jobs. In other instances management may be incapable of providing sufficient chal-

allenges and opportunities to retain good people. The supervisor should help the salesman achieve his maximum potential and the maximum potential of his market, or he will become dissatisfied and seek other employment. Therefore, in appraising sales force turnover, one needs to know the causes of turnover as well as the rate. Similarly, in its appraisal of sales force turnover, management should always re-examine the job description and consider how accurately and fully it still describes the company sales job.

#### DETERMINATION OF SIZE OF SALES FORCE

Since an individual salesman performing the duties and responsibilities set forth in the job description represents one unit of sales manpower, determining the proper number of salesmen is equivalent to determining the number of units of sales manpower needed to accomplish management's sales and profit objectives. Thus, logically the sales and profit objectives, both derived from the sales forecast, should establish the optimum size of the sales force. If the sales job description is accurate and complete, it should be possible to estimate the number of dollars of sales volume each salesman should produce. Dividing this amount into forecasted sales volume and making an allowance for sales force turnover should indicate the number of salesmen needed. These relationships are shown in the following equation:

$$N = \frac{S}{P} + T(S/P)$$

which reduces to:

$$N = \frac{S}{P} (1 + T)$$

where:    *N* is the number of salesmen  
             *S* is the forecasted sales volume  
             *P* is the sales productivity of an individual salesman  
             and    *T* is the allowance for rate of sales force turnover.

Equations of this sort are particularly useful in determining how many new salesmen must be recruited. For instance, assume that forecasted sales volume (*S*) is \$10,000,000, the sales productivity of an individual salesman (*P*) is \$100,000, and the expected rates of sales force turnover (*T*) is 10 per cent. Further assume that the sales force has a present strength of 90 salesmen. Inserting the appropriate figures in the equation above:

$$N = \frac{\$10,000,000}{100,000} (1.10)$$

$$N = 110$$

In this illustration, 20 additional salesmen are needed ( $110 - 90$ ), but turnover is expected to account for 10 departures in the coming year. This anticipated average size of sales force is 100 (i.e.,  $\frac{1}{2}$  of  $90 + 110$ ). Therefore, a 10 per cent rate of sales force turnover represents 10 departures, not 11. During the course of the year, then, this company must recruit 10 men to replace those who leave, and 10 more who represent a net increase in the size of the sales force. Notice that this simplified model does not take into account the training time required for bringing newly recruited salesmen up to the desired level of sales productivity. An actual planning model of this sort would be developed on a monthly or quarterly basis and would have "lead" and "lag" relations built in to allow for the lead time necessary to train new salesmen. If newly hired salesmen spend two months in a full-time training program before being assigned to productive jobs, there is a two-month lag between recruiting and actual increase in sales productivity. Recruiting must lead actual need for new salesmen by two months to adjust for this.<sup>3</sup> Also, the model assumes that sales potential is equal in all territories. When this is not true, the model must be designed to compensate for the differences.

Difficulties encountered in making the estimates for this model vary both with the factor being estimated (N, S, P, or T) and with the company. The crucial estimate for the sales productivity of an individual salesman relies heavily on the accuracy and completeness of the sales job description; but it also depends on management's skill in appraising what can be reasonably expected of those who fill the sales positions. Estimating the sales force turnover rate is largely a matter of analyzing previous experience and should present no insurmountable problem.<sup>4</sup>

The estimate for forecasted sales volume deserves special comment. Most probably the size of the sales forecast in many situations is itself influenced by the size of the sales force which management plans to have. Indeed, any realistic forecast of sales volume necessarily must take into account the number of salesmen at management's disposal. When a company is young, and especially when it is growing rapidly, its potential sales volume often depends primarily on the number and ability of its salesmen. In such a company management may actually derive its sales forecast by multiplying the estimated sales productivity of an individual salesman by the number of salesmen it has, can expect to keep, and can recruit and train in the coming period. But as a company extends its distribution over wider and wider geographic areas, and as it approaches maturity, the

<sup>3</sup> R. S. Weinberg, *An Analytical Approach to Advertising Expenditure Strategy* (New York: Association of National Advertisers, Inc., 1960), p. 98.

<sup>4</sup> For a suggested method of determining size of sales force with the objective of maximizing the profit return as a percentage of the investment, see: W. J. Semlow, "How Many Salesmen Do You Need," *Harvard Business Review*, Vol. 37, No. 3 (May-June 1959), pp. 126-132.



situation reverses itself, for then the size of the sales force is determined by making the sales forecast first, and dividing this by the expected sales productivity of an individual salesman (making adjustments for anticipated sales force turnover, needed training time, and similar factors).

### COMPENSATING SALESMEN

Management has two main decisions to make with respect to the compensation of salesmen. One is on the level of compensation—that is, how much salesmen should be paid. The other is on the method to be used in paying the salesmen.

#### *Determining the Compensation Level*

In determining the level of compensation, the most important factor for management to take into account is the nature of the salesman's job. The duties and responsibilities inherent in the selling job, preferably as set forth in a job description, should be examined in order to determine the quality of salesmen desired. Next, the average amount of annual income needed to attract and hold such men should be determined. This requires investigation of the compensation levels in companies employing comparable grades of salesmen. Results of this investigation should provide management with a clear indication of the decision it should make as to the level of compensation.

Sometimes, management finds that the market value of the desired quality of salesmen is more than the company can afford to pay. A break-even type of calculation helps determine whether this is the case. For example, if the market value for salesmen of the desired quality is \$20,000 per year, and if the average gross margin available for paying salesmen is estimated at 10 per cent of sales volume, then each salesman must produce \$200,000 in annual sales ( $\$20,000 \div .10$ ) for the company to break even. This calculation should be checked against that used for determining the optimum size of sales force. If the two calculations are found to be inconsistent, the job description should be rewritten in more realistic terms. When a revised job description is made available, the two computations should be made again. This process should be repeated as many times as are necessary, until the two calculations are mutually consistent. The size of the sales force and the salesmen's compensation level depend on the firm's capabilities for making sales and earning gross margin dollars.

Far more than for most types of jobs, the compensation level for sales jobs is influenced by external supply and demand factors. Salesmen enjoy greater job mobility than most other employees, and they are often in daily contact with potential employers. With the intention of achieving fairer pay relationships among different jobs, more and more companies

are designing and installing job evaluation and salary administration systems. Marketing management should insist that the monetary attractiveness of sales positions be no less than that for comparable jobs in other departments and, properly operated, a job evaluation and salary administration system will assure this. Normally, however, because of the strong pull exerted by outside firms employing salesmen of similar quality, salesmen receive somewhat higher rates of pay than either production workers or office personnel. Therefore, marketing management must demand that the salary administration system take into account the impact of external compensation levels, if the system is used for setting the level of salesmen's compensation.

#### *Deciding the Method of Compensation*

Having determined the appropriate pay level, marketing management's next task is to decide on the method of payment. Every method for paying salesmen represents some combination of the four elements of compensation: (1) a fixed portion (salary), (2) a variable portion (commission, bonus, or participation in profit sharing), (3) an element providing for either the reimbursement of expenses or payment of expense allowances, and (4) "fringe benefits" such as paid vacations, pensions, insurance, and stock purchase privileges. Since "expense reimbursement" and "fringe benefit" are never used alone, we may exclude them from consideration. Thus we find that there are three basic methods of payment: (1) straight salary, (2) straight commission, and (3) a combination of salary and one or more variable features.

Each of these methods represents a different weighting of the relative importance of two underlying purposes of compensation—to provide management with the power to direct salesmen's activities, and to furnish salesmen with the incentive to work productively and efficiently. At the two extremes are the straight salary and straight commission methods. The straight salary method, at least in theory, should provide management with the maximum power to direct salesmen's efforts along the potentially most productive lines. The employer guarantees a total fixed income to the salesman and has the right to ask him to engage in activities that are not directly productive of sales. Under the straight commission method, where the amount of a salesman's earnings is closely related to his selling efforts, he properly resents demands on his time for unproductive activities by his employer. The justification of the straight commission system is that it provides salesmen with the maximum of direct financial incentive to strive toward high selling efficiency. Neither straight salary nor straight commission, however, are as widely-used as the combination method. By including both a fixed element and one or more variable elements in their plans for paying salesmen, companies using combination

methods seek both to secure the needed control and to furnish salesmen with the necessary motivation.

The problem of deciding on a method of payment reduces to one of determining which elements to include and the proportion that each should bear to the salesman's total income. Not every company does, or should, include all four elements. Each should try to select the combination of elements that will help the most in working toward the over-all goal of maximizing long-term net profits. In the following sections, we will discuss some of the more important considerations involved in the solution to this problem.

**BALANCING CONTROL AND INCENTIVE.** The main reason why most companies use the combination plan is that it makes it possible for management to achieve a closer balance between control and incentive. Companies using straight salary rely heavily on it as a means to control and direct salesmen's activities, and must look elsewhere for ways to provide incentives. Those companies choosing straight commission tend to view it as the main way of providing salesmen with incentives, and managements in such companies must find other ways to achieve control over salesmen. Of course, those with salary methods can always use salary increases as financial incentives and those with commission methods may use changes in commission rates as controls. But, for the most part, users of the straight salary method must rely either on offering liberal fringe benefits, or non-financial items such as salesmen's medals or letters of commendation for good or excellent performance, to provide salesmen with sufficient incentives to do their jobs well, and these are often the best incentives that can be used with men whose incomes are well above subsistence-level. Similarly, companies using the straight commission method may seek the needed control over salesmen through either the fringe benefits offered or by resorting to such non-financial controls as close supervision. In all companies, obviously, the provision to salesmen of opportunities to advance to managerial levels both gives management a degree of control and salesmen an incentive to gain prestige.

So far as the compensation plan is concerned, however, balancing control and incentive mainly involves deciding on the ratios that the base salary and the financial incentive should bear to the total compensation. Where companies wish to allocate a very large portion of salesmen compensation to salaries, the amount remaining for commissions may be so low as to provide insufficient incentive for salesmen without raising total selling costs. In such cases, assuming that minimizing total selling costs is of crucial importance, management would clearly be better off not to try to use a combination method. There are also opposite cases where the incentive portion of a combination plan bulks so large in the total that

salesmen tend to neglect duties for which they are not directly compensated. Analysis of a large number of compensation plans indicates that the most common distribution of payments is approximately 70 per cent salary and 30 per cent incentive and other variable elements.

**RECOGNITION OF PERFORMANCE DIFFERENCES.** Since outstanding salesmen should be paid more than those who are mediocre or ineffective, salesmen's compensation plans should be designed to result in differential payments according to differences in performance. At the same time, however, it is important that the plan not operate in such ways as to penalize or reward salesmen for factors outside their control, such as differences in territory potentials.

The machinery for differential payment may operate either automatically or at the discretion of management. Some variable elements, such as commissions based on sales volume, serve as automatic devices for differential payment. If the variable element is a bonus paid for accomplishing a specific task, e.g.; one for attaining a certain percentage of the sales quota or for performing given promotional duties, differential compensation payments result more or less automatically. When salary is used to effect differentials in compensation, management must make salary adjustments often enough for them to accurately reflect changes in individual performance. Most managements seem to favor using the commission or bonus element as the main instrument for recognizing performance differences—it not only operates automatically but readily makes downward as well as upward adjustments paralleling changes in performance. By contrast, managerial inertia usually causes salary adjustments to lag behind performance changes, and it is rare for them to be made in any direction but upward.

**SIMPLICITY.** From management's standpoint, it is advantageous to keep the compensation plan as simple as possible. Simple compensation plans normally cost less to administer than complicated ones. And, although a complex plan may often provide greater refinements in stimulation and reward, improvements in performance may not be enough to offset the increased administrative costs.

There is another reason for keeping the compensation plan as simple as possible. The method of compensation should not be so complicated that the average salesman will have difficulty calculating his earnings. But it should be borne in mind that what one group of salesmen considers complicated may be thought ridiculously simple by other groups. Quite similar compensation plans may appear hopelessly complex to a wholesale grocery salesman but perfectly easy to understand to the engineering-trained salesman of electronic components.

**COMPANY FINANCIAL POSITION.** The state of company finances often influences the particular design of the plan chosen. Companies with strong working capital positions tend to favor the straight salary system, because it results in sales compensation expenses fixed in total amount but varying inversely percentagewise with sales volume. Smaller companies, especially those short of working capital, prefer the straight commission system in which compensation expenses vary in total amount, but are fixed as a percentage of sales volume. Combination plans differ in amount and type of financial flexibility, depending on the relative proportions of salary and commission built into them. Hence, from the financial viewpoint, combination plans are compromises whereby a company may achieve the degree of financial flexibility considered desirable by its management. Perhaps that is a major reason for their increasing popularity.

#### **DETERMINING THE PERSONAL SELLING APPROPRIATION**

The logical starting points for determining the amount of the personal selling appropriation are the specific sales and profit goals established by top-management for the period just ahead. Marketing plans, drafted with a view toward achieving these goals, ultimately must be translated into the types and amounts of marketing effort required. Sooner or later, therefore, management deals with the problem of converting these types and amounts of marketing effort into dollar estimates of the costs involved. Thus, an increase in the sales volume objective may call for the hiring of a certain number of new salesmen, their training, providing them with transportation and expense allowances, securing and assigning additional supervisors, and the like. The next step is to convert each activity into an estimate of the dollar cost. Therefore, in building the personal selling appropriation, management must do two things: (1) estimate the volume of performance for each required activity and (2) convert these estimated performance volumes into estimates of dollar costs.

As we indicated earlier, before determining the personal selling appropriation, management should first determine the *total* promotional appropriation based on an optimum marketing mix; then, both the advertising and personal selling appropriations should be apportioned according to their relative importance as elements in the marketing mix. If it were possible to follow this approach, theory suggests that identical returns in terms of net profit should be produced by the last dollar invested in personal selling and the last one invested in advertising.

Actually, neither advertising nor personal selling is purchased in dollar-size units. Advertising is bought in terms of pages, agate lines of space, half-hour programs, 30-second and 15-second commercials, etc. Personal

selling effort is purchased in terms of units of sales manpower—the incremental purchase is a salesman and not a dollar's worth of selling effort.

Some administrators mistakenly think that it is possible for them to buy personal selling effort in dollar-size units when they use straight commission systems. They seem to be accounting only for the commissions paid to salesmen for efforts which result in sales. Normally, however, some provision must also be made for reimbursing expenses incurred in connection with calls, both those where sales were made and where they were not. Otherwise, commission salesmen are likely to "skim the cream" and call on only those accounts where they are sure to get large orders. Furthermore, while payment of commissions, salaries, or both, and reimbursement of expenses are large items in the personal selling appropriation, they are by no means all of it. The total of that appropriation must also be adequate to cover expenses of recruiting, selecting, training, providing motivation and supervision, and of performing related sales force management activities. It must also make provision for paying the salaries and expenses of sales executives and for covering other overhead expenses.

A relationship exists between the size of the sales force and the amount of the personal selling appropriation, but it is not a direct type of relationship. It varies not only with the company but with the decisions made by management. In apportioning the personal selling appropriation, management is continually faced with such questions as these: Should we hire five additional salesmen at a total annual cost of \$75,000, or should we invest the same amount in refresher training for present salesmen? Should we add sales supervisors or use the same number of dollars for conducting sales contests? If such questions were resolved rationally, there would be an equating of the marginal productivities of alternative ways of spending the personal selling appropriation. But, in practice, such allocations are made largely on intuitive grounds. Management experiments constantly, always striving for the optimum allocation pattern. But since there is no known way for measuring or predicting the relative effectiveness of expenditures on the different activities, such allocations have to be made by trial and error methods.

#### **ALLOCATING PERSONAL SELLING EFFORT**

In this section, we assume that management has already decided on the size of the sales force and on the apportionment of the personal selling appropriation. Management, in other words, has committed itself to some specific number of salesmen and to a final plan for spending the personal selling appropriation. These important decisions necessarily must be made before two other decisions can be made: in the language of "practical sales management," these are the problems of (1) assigning salesmen to

territories and (2) routing and scheduling their calls on customers and prospects, so as to make the most of their selling time.

#### ***Assignment of Salesmen to Territories***

Assigning a salesman to a territory restricts his efforts to a given geographical area containing some grouping of customers and prospects. Each territory, with its particular grouping of customers and prospects, represents some potential volume of sales to the company. Whenever a salesman is assigned to a territory, management, in effect, has matched some level of selling skill with the amount of sales opportunity it believes present in that territory. Therefore, both the relative abilities of salesmen and the relative sales potentials of territories should be considered in assigning specific salesmen to specific territories. Too often, however, these problems (of appraising salesmen's efficiency and evaluating territorial sales potentials) are treated independently of each other. Since salesmen differ in efficiency and territories differ in sales potential, a *rational* assignment of salesmen to territories would put the best salesman in the most fertile territory, the second best salesman in the second most fertile territory, and so on.<sup>5</sup> Only if the assignment is made in this way will it be possible to maximize total sales in the entire market. Probably, practicing sales managers attempt to assign their salesmen this way, but little doubt exists that in most companies assignment decisions are made intuitively rather than rationally.<sup>6</sup>

#### ***Routing and Scheduling Salesmen's Calls***

Once salesmen have been assigned to territories, the next problem is to use their available selling time to maximum advantage. This is largely a matter of minimizing the amount of "waste" time, and of securing the best allocation of productive selling time among individual accounts and prospects in each territory. Included within the meaning of "waste" time, as used here, are hours spent in travel between calls, time spent waiting for interviews, and other time during regular selling hours not used for performing either selling or non-selling duties (i.e., time "idled away").

Not every company uses formal planning and control of salesmen's routes and call schedules. In some instances, management's philosophy appears to be that salesmen are the best judges of how they should spend their time. In other instances, the quality of the salesmen is so high that

management feels any move toward formal routing and scheduling is inappropriate for such reasons as these: it is extremely difficult to predict the amount of selling time each account will require, as happens when salesmen sell products designed to each customer's specifications; the company uses "side-line" salesmen who represent several companies and, therefore, are virtually in business for themselves; or salesmen are engaged in door-to-door selling, where nearly every householder is a prospect (e.g., the situation in selling encyclopedias), and where salesmen have to adjust their routes and calls to accommodate the "at home" habits of each prospect.

Aside from the exceptions noted above, most companies can derive great benefits from formal routing and scheduling of salesmen's calls. Besides increasing the chances that salesmen will be on the job when they are supposed to be, formal route and call schedules make it easier to contact them in order to provide needed and helpful information or last-minute instructions. Moreover, planning a salesman's route for him, if done intelligently and efficiently, eliminates much back-tracking, travel time, and waiting time. Furthermore, providing a salesman with a schedule of calls makes it possible to adjust the frequency of call to fit the needs of customers and prospects more precisely, thus securing improved coverage of the territory.<sup>7</sup>

#### **APPRAISING SALESMAN PERFORMANCE**

Before examining the problems involved in evaluating the performance of salesmen, it should be noted that management alone bears the ultimate responsibility for maximizing the net profit contribution of the personal selling effort. Management makes the basic decisions: the type of salesman needed, the content of the job descriptions, the size of the sales force, the level and method of compensation, how individual salesmen should be deployed throughout the marketing area, and so on. None of these decisions can be made intelligently without considering their relation to the others. Furthermore, none should be made without careful consideration of its probable influence on attainment of sales and profit goals, and of the effect its probable cost will have on the personal selling appropriation. Success or failure in maximizing the net profit contribution of the personal selling effort is the responsibility of management, not of the salesman, and it is managerial excellence in making and implementing these decisions that determines the probable degree of success.

Salesmen are the main instruments through which management tries to



maximize the net profit contribution of the personal selling effort. They are instruments of management's own choosing and training. The performance of salesmen, individually and collectively, directly affects the success of the personal selling effort. So it is imperative that management have measures of the performance of salesmen. Unless there are such measurements, management is greatly handicapped in predicting the probable results of its decisions. Moreover, measurement is absolutely essential for the making of rational decisions with respect to such questions as which salesmen to discharge, which to train further, and which to reward. Management needs, therefore, to measure the performance of salesmen, both for purposes of decision-making and for control.

Not only must there be measures of salesman performance, but there must be ways of distinguishing good from poor performance. Standards, or norms, must be established against which the performance of individual salesmen may be appraised. For decision-making and control purposes, the most useful performance standards are quantitative ones, but most companies also need to utilize qualitative criteria of appraisal.

#### *The Job Description and Performance Appraisal*

One place to start in appraising the over-all performance of a salesman is with the job description. If it is a good one it will not only detail the salesman's duties and responsibilities but should also spell out the performance levels considered satisfactory by management. Comparison of what the salesman does with what the job description says he should be doing provides insight into his total performance. The trouble with the job description, however, is that many of the salesman's duties and responsibilities do not lend themselves to quantitative measurement. How, for example, can management measure how much good will a salesman build? Or, what numerical measures are there for the salesman's mental alertness in dealing with customers? Probably the best that can be done is to define, as clearly as possible, what performance is expected for each of the listed duties and responsibilities. Some definitions may include quantitative performance standards (e.g., the frequencies with which calls should be made on different classes of accounts), but most necessarily have to be phrased only as qualitative statements of what is expected by management.

#### *Quotas*

Quotas are probably the most common yardsticks used by management to measure the performance of salesmen. A quota is nothing more than a quantitatively expressed goal assigned to a specific marketing unit, such as to a salesman or territory. On the basis of his past performance a salesman might be expected to produce a predetermined volume of sales, or on

the basis of measured market potential a territory might be expected to yield a predetermined volume of sales. Quotas may be in terms of dollar or unit sales volume, gross margin, net profit, expenses, calls, number of new accounts, amount of dealer display space obtained, and other measurable units.

A major (and obvious) problem in working with quotas is that of determining their size. Consider, for example, the dollar sales volume quota. Salesmen's efforts do not always produce sales in the period for which their performance is being evaluated, and the results of a salesman's current efforts may materialize only over many future operating periods. In addition, each salesman is faced with different working conditions, many of which influence the relative ease with which sales are made. Territory by territory, for example, there are variations in the strength of competition, the time required for travel, and the amount of sales potential present. Thus, it is extremely rare to find a company which is justified in assigning identical sales volume quotas to all its salesmen. Because of competitive, physical, and sales fertility differences among territories, then, the sales volume quota for each salesman should be set individually. There is another important reason for individually-set quotas—the salesmen also vary in selling efficiency because of differences in training, experience, and native abilities. There is very little incentive value in assigning a salesman a sales volume goal that he hasn't a chance of reaching.

Another major problem in working with the sales volume quota is that of distinguishing sales results produced by the salesman from those due to other causes. Advertising, for instance, is often at least a partial influence in making many sales, but it is usually the salesman who writes the actual order. At other times, the salesman may write the order, but his supervisor or branch manager may actually have been the major influence in the customer's decision to buy. In such cases, it is impossible to determine the exact extent of the salesman's contribution.

The sales forecast should be the main basis for setting sales volume quotas, since carefully prepared sales forecasts, when intelligently broken down, result in quotas that are reasonable and thus attainable. By breaking the sales forecast down into manageable parts—i.e., into sales volume quotas for individual salesmen—management can specifically define the results it expects from each man's efforts. However, it should be recognized that a sales volume quota can be no better than the sales forecast from which it is derived. If the forecast is little more than a wild guess, the quota derived from it will be no better. Improvements in sales forecasts and sales volume quotas go hand in hand.

In addition to providing management with a yardstick for appraising the efficiency of salesmen, sales volume quotas have some incentive value. Salesmen are likely to work much harder when quotas are used than when

they are not, especially if each quota is rationally determined—i.e., only after consideration is given to territorial differences and variations in salesmen. The fact that there is such a goal, together with the knowledge that management *expects* its achievement, does cause most salesmen to do their best to achieve it.

### CONCLUSION

Many important marketing decisions have to be made in the area of personal selling. Rational decision-making in this area is possible only if management has two powerful tools at hand—a reliable sales forecast and complete and accurate sales job descriptions. In excellently-managed companies, the decision made with respect to the kind of sales force needed is expressed in terms of complete and accurate job descriptions. Such job descriptions provide a sound basis for planning the activities involved in managing the sales force: recruiting, selecting, training, compensating, motivating, supervising, and controlling. In determining the size of the sales force, management must consider both the sales job description and the magnitude of the sales forecast as well as such factors as the rate of sales force turnover. Decisions on levels and methods of salesmen's compensation are greatly influenced by the duties and responsibilities detailed in the job description which, in effect, defines the quality of salesmen management wants to employ. Management's detailed plans concerning (1) the types and amounts of marketing effort required for realizing the sales forecast and (2) the size of the sales force are the two major items influencing the decision on the size of the personal selling appropriation. Decisions on the size of sales force and apportionment of the personal selling appropriation necessarily precede and affect decisions on deploying individual salesmen throughout the market and utilizing their efforts to maximum advantage. Again, both the job description and the sales forecast see important service in the appraisal of salesman performance. Rational decisions in the personal selling area are interlocking ones, and the twin keystones which bind them together are the sales job description and the sales forecast.

### QUESTIONS AND PROBLEMS

1. Compare the following types of salesmen:
  - a. order-taker and order-getter
  - b. missionary salesman and sales engineer
2. Do you favor or oppose the proposal that salesmen should specialize either in sales maintenance activities or in sales

- development? Why? If you worked for a company that specialized its sales force in this way, would you rather be assigned to sales maintenance or sales development? Why?
3. What is a sales job description? Suggest some ways a company might go about obtaining job descriptions for its salesmen. Discuss the relationship of the sales job description to recruiting, selecting, training, supervising, and controlling salesmen.
  4. The sales force of a certain manufacturer numbered 50 men at the start of the year and 80 men at the end of the year. Twenty men either resigned, were fired, were promoted, or otherwise left the sales force during the year.
    - a. Compute the rate of sales force turnover.
    - b. Assuming continuation of the present rate of sales force turnover, how long will it take to replace the entire sales force?
    - c. Supposing this manufacturer says: "What good does it do me to know my rate of sales force turnover? How do I use this statistic?" What advice would you give him?
    - d. Later on this manufacturer hears of a small company which had 5 salesmen at the start of the year, 8 men at the end, and lost 2 men during the year. He concluded that since this company and his own both had the same rate of sales force turnover, both must have been equally well managed. Would you agree? Why or why not?
  5. Suppose a certain manufacturer has a forecasted sales volume of \$8,000,000, the sales productivity of an individual salesman is \$160,000, and the expected rate of sales force turnover is 20 per cent. Assume further that there are presently 40 men on the sales force.
    - a. What is the "needed" size of the sales force in this case?
    - b. What is the anticipated average size of sales force?
    - c. Suppose that it costs \$10,000 to bring a new salesman up to the \$160,000 sales productivity level. How much money can this manufacturer save, if he succeeds in holding the rate of sales force turnover to 10 per cent?
  6. Discuss the changes that occur in the relationship of the sales forecast to the size of the sales force as a company expands its operations and eventually matures.
  7. The management of a newly-organized company estimates the market value for salesmen of the quality it desires at \$12,000, and further estimates the average gross margin avail-

able for paying salesmen at 15 per cent of sales volume. How much annual sales volume must each salesman produce for the company to break-even?

8. How might break-even computations be used in setting the boundaries for salesmen's territories? To what extent would these computations be affected by the method of sales compensation used?
9. Some cities have enacted laws, known as "Green River Ordinances," which regulate or sometimes even prohibit house-to-house selling. Why are such ordinances passed? Why not pass similar ordinances to prohibit or regulate the activities of salesmen calling on business establishments? Why not pass laws requiring salesmen to be licensed and to meet certain minimum requirements, such as successful completion of a formal educational program or passage of a state-conducted examination?
10. "With almost complete literacy in this country, with the progress of automation, with the tremendous coverage afforded by radio and TV, and with the increasing effectiveness of advertising, the age of the salesman is fast disappearing. By the time we reach the year 2000, salesmen will be as rare as dinosaurs' eggs." What is your reaction to this statement by a critic of personal selling? Are salesmen in general in any great danger of being supplanted? What about retail sales people? Wholesalers' salesmen? Manufacturers' salesmen?
11. Professor Dale Houghton of New York University in a study of marketing costs reported in *Printers' Ink* (February 1, 1957, p. 54) that 64 per cent of the consumer goods companies he studied spent more for the sales force than for advertising. Professor Houghton also found that among industrial goods companies, the cost of the sales force almost invariably exceeds by many times the cost of advertising. What conclusions might be drawn from these findings?
12. Answer the following questions pertaining to salesmen's compensation:
  - a. What factors should be taken into account in setting the compensation level?
  - b. What are the main factors influencing the decision as to compensation method?
  - c. Compare the three basic compensation methods from the viewpoints of (1) management, (2) the salesmen, and (3) the customers called on by salesmen.

- d. Explain how control and incentive are balanced under each of the three basic compensation methods.
  - e. Why do managements generally prefer to use the commission or bonus element in compensation as the main instrument for recognizing performance differences among salesmen?
  - f. What is meant by "skimming the cream"? How does compensation level influence this tendency? Compensation method?
- 13. Compare and contrast the methods for determining the personal selling appropriation with methods for determining the advertising appropriation.
  - 14. What information does management need in order to make rational assignments of salesmen to territories? What research methods might be used in obtaining such information?
  - 15. Under what conditions should companies use formal routing and scheduling of salesmen's calls? Under what conditions should salesmen route and schedule themselves?
  - 16. Why *must* management have measures of the performance of salesmen? How useful is the job description in making performance appraisals? What problems are encountered in using quotas as yardsticks of sales performance?
  - 17. Discuss the relationship of sales forecasting to the setting of sales volume quotas.

M A R K E T I N G

S T R A T E G Y

# 21

In solving most major marketing problems, management must make several decisions—each seemingly independent, all in fact closely interrelated. For example, a decision to increase or decrease the price on a product by some substantial amount means that management must re-evaluate other components of the marketing mix. But if the decision is to change the price by some small amount, there is usually little need to consider possible changes in product, promotion, distribution, or organization policies and practices. If a manufacturer now prices his product at **\$42** and he is considering raising the price to **\$50** (a fairly large price increase) he should re-evaluate and

possibly make decisions on other components of the marketing mix. But if he plans to raise his price by only one dollar, such a re-evaluation of decisions would not be nearly as important. Thus, since a significant change in price can affect decisions on such things as product, promotion, distribution, and organization policies, the ultimate success of the price-change decision (when it is put into effect) depends on management's skill (and luck) in choosing the optimum combination of decisions. We have, in Chapters 15 through 20, considered each of the major decision areas in marketing; let us now examine them collectively as interrelated parts of a total marketing strategy.

A particular firm's marketing strategy is concerned with identifying opportunities to serve customers and serving them so well that it is difficult for competing firms to take business away on a profitable basis. Marketing strategy, then, involves making a competitive search for customers, and the successful firm must make a better assessment of relative marketing opportunities and obstacles than its competitors. The marketing strategist, like the military strategist, may adopt an offensive or defensive approach. When a marketer's products are already firmly established in the market, he may be strongly tempted to adopt a defensive approach—i.e., to maintain a holding action. There is, however, always considerable danger in attempting to maintain or defend the *status quo* in a marketing situation, since this means yielding the initiative to competitors who may, for example, develop product innovations which might conceivably be successfully marketed, breaking established customer loyalties in the process. Seven-Up, for instance, first broke into the soft drink market not by introducing another cola, root beer, or other standard flavor, but by developing and marketing an entirely new flavor. As Seven-Up succeeded in carving out a market for itself, other bottlers of soft drinks, such as Coca-Cola and Pepsi-Cola, abandoned their predominantly defensive marketing strategies and took the offensive by introducing new flavors of their own. Thus, had the Coca Cola Company continued its defensive strategy, it would merely have striven to retain or increase its share of the cola drink market. But with the introduction of the lime-lemon flavor to the soft drink market, the total market expanded, and the company that confined itself to producing only the older flavors found itself with a shrinking share of the total market. Instead of choosing this alternative, Coca Cola management chose to compete aggressively by introducing its own lime-lemon drink.

### COMPETITIVE SETTINGS

The importance of and need for marketing decisions varies with the type of competitive setting. In a capitalistic society, three kinds of competition exist: pure competition, imperfect competition, and oligopoly.



*Pure Competition*

If we were to accept the classical economist's definition of pure competition, including the assumptions underlying this definition, we could reason that no marketer should be concerned with the plans and actions of his competitors. Essentially, this definition regards pure competition as a market situation where there is a large number of small sellers, none of whom is powerful enough to control or to influence the prevailing market price. In formulating this definition, the classical economist assumed that: (1) no single producer is so large relative to the market that he can appreciably affect the total supply of the product put on the market, (2) the products of all competing sellers are identical in all respects so consumers are indifferent as to which sellers they patronize, and (3) all buyers are completely informed of the prices quoted by all competing sellers. If these assumptions were wholly valid, no seller would have to be concerned with the plans and actions of his competitors: each seller would be too small to gain business at the expense of his competitors through price-cutting; it would be impossible to compete by offering a "better" product (since product differentiation is ruled out); and it would be futile to advertise or carry on any other sort of promotional activity (inasmuch as all buyers are already fully informed and buy exclusively on the basis of price)

Today, pure competition is almost non-existent, the closest approach to it being found in the cases of certain agricultural products, such as the crops of truck farms. In marketing such products, the really important marketing decisions are those involved with physical distribution: moving the products in time and space. A New Jersey truck farmer, for example, has the choice of shipping his string beans to wholesale produce markets in Philadelphia or New York, or he may decide to delay sending them to market by a day or two in anticipation of a rise in price. But if the truck farmer is shipping lettuce or strawberries, the perishability of his produce may remove even the option of storing his output a short time in the hope of receiving a higher price

*Imperfect Competition*

In a modern economic society, such as in the United States, most firms operate under conditions of imperfect, or monopolistic, competition, which means that all or some of the assumptions of pure competition do not hold in the marketing situations confronting most firms. In most industries there are some producers who are large enough to significantly influence the total supply of the product—e.g., Whirlpool-Kenmore in the washing machine industry. Nearly every seller's product, whether it be peanut but-

ter or carpets, can be differentiated (at least in the minds of consumers) from competitive products. Most consumers are convinced that competing brands of even such "identical" products as soap, cigarettes, and coffee are not exactly alike, so individual producers have opportunities to build brand loyalties among consumers and, hence, to control different shares of the total market. Even of greater significance is the fact that most consumers are not really fully informed about the offerings of competing sellers, usually not even adequately informed. This is illustrated by the ability of competing retailers to sell identical branded products at different prices. Indeed, in making many buying decisions, the individual consumer is often overwhelmed and confused by the sheer variety of products from which he must make his choice. Thus, the conditions of imperfect competition provide not only marketing opportunities for individual producers and resellers, but also clearly call for skilled marketing planning and appropriate action in the competitive struggle for survival and success (i.e., profit). If a seller has it within his power to differentiate his product, this provides him with a market message to relate through his promotional programs, and both of these provide him with some degree of control over the price of the product. Thus, the Morton Salt Company, by differentiating its products through excellent packaging, can command higher than normal prices for salt.

### *Oligopoly*

In recent decades, an increasing number of industries in the United States have been moving in the direction of *oligopoly*—i.e., toward reducing the number of firms in an industry to a group small enough to be individually identified and known to each other. This is still imperfect competition, but in an extreme form. In the United States, oligopolies have developed in such industries as automobiles, appliances, soap and detergents, and shoes in the consumer goods field, and in steel, aluminum, textile machinery, and machine tools in the industrial goods field. There is a well-established long-range trend of expansion by the more successful firms, and of failure or disappearance (through merger) by the less successful. Dramatic examples are provided by the soap and auto industries, both having been reduced from a very large number of competitors to a very small group in a period of less than fifty years. This indicates that there will probably be more, not fewer, oligopolistic industries in the future. Governmental agencies and congressional investigating committees have been trying to discourage the merger movement as a threat to free competition. Proposed mergers may be denied and completed mergers may be declared illegal if they appear to be in conflict with the "anti-monopoly" laws. However, the trend toward oligopoly is still clearly

going on through the slower process of expansion by the successful and failure by the others.

Oligopoly in an industry produces the most aggressive kind of competition. When there is a small number of large producers in an industry, the competitive moves of any one can have a significant effect on the market, so when one of the large soap companies introduces a new kind of liquid detergent, its competitors face the danger of a rapid loss of market if they do not respond immediately. For this reason, competitors' actions are watched closely and marketing changes by one firm are almost certain to be quickly matched or otherwise countered by its competitors. Changes in one competitor's product, in his promotion, in his distribution, if they appear to hold some promise of improving his competitive position, are imitated, copied, or improved upon by his competitors as rapidly as time will permit, but price changes by individual industry members can be and are matched by others almost immediately. Industry-wide price adjustments are often made so quickly that they appear to result from the collusive action of competitors when, in fact, there has been no collusion whatever. In recent years an announcement of a \$100 price reduction on Chevrolets was followed almost immediately by an equal reduction on Fords. Ford management could not ponder whether or not they could afford to reduce prices; they simply recognized that, to retain their share of the market, they could not afford to ignore the competitor's action.

It does not follow that, because most oligopolies are highly competitive, oligopolies are never guilty of monopolistic activities. And, when collusive action is attempted, the limited number of competitors make cooperative action particularly easy. As a case in point, in June 1959, a grand jury was convened in Philadelphia to investigate the pricing practices of electrical goods manufacturers, and subsequently charged six major manufacturers with participating in a conspiracy designed to fix prices on bids for government contracts. Although such conspiracies are often found among small local competitors, they are apparently rather unusual among large national competitors.

#### **MARKETING DECISIONS IN A COMPETITIVE SETTING**

In any industry characterized by conditions of imperfect or oligopolistic competition, an individual producer, skilled in planning and applying the marketing forces under his control, has the power to capture the loyalty of certain market segments on a more or less permanent basis. This causes each producer to carefully consider the actions of competitors and their possible reactions to any marketing decision he might make. Every area of marketing decision therefore, is influenced to some extent by this need to consider the actions and reactions of competitors.

### *The Product*

Whether a producer is an innovator or a follower, his product decisions (if they are to prove successful) must take into account probable timing of competitors' actions. For example, much of the careful research and testing that goes into a manufacturer's development of a new product may be wasted, if some competitor manages to introduce a similar new product to the market earlier—the competitor, then, gets not only credit for the innovation but has first “crack” at the market. In attempting to side-step such occurrences, manufacturers sometimes feel compelled to market new products that are not yet adequately tested. Furthermore, when one company introduces a new or greatly improved product, its competitors must be prepared to develop and introduce competitive substitutes as soon as it is clear to them that the innovation is experiencing market success; this, too, may cause some competitors to sacrifice extensive testing in favor of early market introductions of their substitutes. Business history contains many examples of firms that slipped from positions of industry leadership to much lower status (or even that disappeared entirely), following the introduction of new products that these firms were unwilling or unable to copy, or for which they were too slow in introducing competitive substitutes. Such an example was recorded in the washing machine industry after the mass introduction of fully-automatic washers in the decade after World War II. The total number of washing machine manufacturers was greatly reduced due to the attrition of manufacturers who failed to introduce automatic washers or who delayed too long in doing so. In 1951, after leading the industry for close to 30 years, the Maytag Company dropped to second position among laundry appliance manufacturers while the Whirlpool Corporation rose to first. Several trade magazines attributed this change to the introduction of an automatic washer by Whirlpool and failure to do so by Maytag.<sup>1</sup> However, the introduction of automatic machines did not guarantee success, since some of the companies that failed had eventually introduced automatic washers, but failure to conform to the new product innovations did apparently provide a guarantee of failure.

### *Channels of Distribution*

To use the military analogy of strategy, channel decisions are comparable to the military commander's choice of battle field. Products, if they are to compete successfully, must be available for purchase in places where buyers expect to make such purchases. If most customers, for instance, expect to find photographic film in drug stores and customarily buy their

<sup>1</sup> “Household Clothes Washers and Washer-Dryer Combinations,” Marketing Research Department, *Redbook Magazine*, October 1957. McCall Corporation New York.

film requirements in such outlets, it will probably be more difficult for a film producer to sell his product through variety stores or hardware stores. Some film, to be sure, could be marketed through these unconventional outlets but, assuming other marketing circumstances to be equal, it should be much easier to sell film through outlets where most people expect to buy film. Similarly, a consumer, seeing film in a hardware store, might buy it on an impulse basis when he is reminded that he needs film, but when he starts out with the primary purpose of buying film, he will go to a store that "always" carries film. Similar generalizations hold with regard to other levels of distribution. Retailers seeking to buy a supply of some particular product ordinarily contact distributors who they know handle such products. Nevertheless, it is sometimes not possible for a particular producer to use such "customary" channels. For example, druggists already may be stocking two makes of film and, hence, may be unwilling to stock a third (and perhaps less well-known) brand which might result in larger inventories with no increase in sales volume, and, therefore, lower rates of stockturn. In such a circumstance, the marketer of a new film may find that his only feasible alternative is to persuade other types of retailers, such as grocers, to stock his brand, trying to overcome the "unconventional outlet" disadvantage through offering a better product, a lower price, a more effective promotional program, or some combination of these. Many such instances have occurred where a producer who was late in entering a particular market discovers that conventional and traditional outlets are closed to him. These instances are especially common in marketing situations where competitors adhere to selective distribution policies—i.e., in situations where each retailer, distributor, or agent customarily limits his stock to noncompeting products of noncompeting manufacturers.

#### *Physical Distribution*

Marketing decisions on physical distribution are comparable to the military commander's decisions on logistics.<sup>2</sup> Transportation (place) and storage (time) decisions are strongly influenced by the actions of competitors. If, for example, a Chicago luggage manufacturer has no competitors with plants or warehouses west of the Mississippi, he may serve the Washington and Oregon market areas directly from the Chicago factory by ordinary rail shipments. Suppose, however, that a competitor locates a new plant in Seattle; the Chicago manufacturer then finds it necessary to use either a faster transportation method, such as air

freight, or change his storage method, perhaps by setting up his own warehouse in Seattle. His selection from these two alternatives will depend on which provides the lowest total expenditure on transportation, storage, and investment in inventories. If the Chicago manufacturer does not choose to adopt either of these new procedures, the competitor with a Seattle-based operation may gain a strong competitive advantage through his ability to provide faster delivery service to customers in that area, enabling them to reduce their own inventory investments because of quick delivery.

### Price

The price a seller places on a product must bear some relationship to prices of competitive products. Although some products of superior quality or reputation may be marketed successfully at higher-than-average prices, such prices should never be allowed to vary too far from the average of competitive prices. So when competitive prices drop, the marketer of the quality product must give serious consideration to cutting his price as well. And, also, when competitive prices rise, the marketer of the quality product can consider raising his price. Most marketers who desire to take "the offensive" prefer not to rely on price as the main competitive weapon, so they attempt to gain differential advantages over their competitors by stressing other elements in the marketing mix. Thus, when price uniformity prevails in an industry, this often indicates industry members' keen awareness of each other's prices coupled with a common desire to avoid using price as the main basis of competition.

Despite the general reluctance of marketers to use pricing as a competitive weapon, there are times when price competition offers the only or the most logical choice of action. Retailers opening new stores often offer sweeping price reductions on a temporary basis to overcome consumers' established shopping patterns and attract them into the store. The same sort of strategy may apply with the introduction of a new product or entry into a new market. And if a competitor introduces a new product into the market, a price reduction may be a necessary competitive tactic to retain customers. Price reductions are a regularly used method of clearing out previous years' models and seasonal merchandise. A few marketers use price regularly as a primary competitive device, but to do so successfully, they must combine a high level of efficiency with the acceptance of low profits per unit. At the retail level, R. H. Macy's department store in New York, with its policy of consistently selling six per cent under competing department stores, is a highly successful competitor on the basis of price. Even at Macy's, however, price is used only as one element in competitive marketing strategy.

**Promotion**

The promotional strategy chosen by a manufacturer—i.e., the methods he chooses in his efforts to stimulate market demand—are closely related to his sales expectations (properly derived from sales forecasts). If, for example, he believes that a five per cent sales increase is possible during the coming year, he will try to plan an advertising program and/or increase the strength and effectiveness of his sales force to the extent he thinks necessary to achieve the higher sales volume. Most such changes in a manufacturer's promotional strategy, however, are based on the important assumption that the main competitors will not make drastic changes in their levels of promotional activity. Thus, if a leading firm in an industry decides to increase its annual advertising budget from \$10 million to \$15 million, its main competitors will find themselves generally having either to plan similar increases or risk losing their present shares-of-the-market. If market demand for the product is expandible, all firms in the industry may benefit from the increased advertising—i.e., if industry sales increase enough to more than cover the costs of increased advertising. If, however, market demand is not expandible (assuming each competitor's advertising is as effective as the advertising of other firms in the industry), total industry sales will not increase and the added advertising simply reduces each firm's gross margin and its net profit.

Promotional effort provides a means whereby a producer can gain differential advantage over his competitors. It is not only the number of dollars invested in advertising that is important, but also the effectiveness with which these advertising dollars are used. Even though two competitors may match each other's promotional expenditures, one may get back many more sales dollars from his investment than the other. Two advertising campaigns may cost the same number of dollars, but one, because it uses more powerful selling appeals, reaches a larger or more receptive audience, or for some other reason may produce considerably more sales volume than the other. Similar generalizations can be made as to the productivity of the sales forces of different companies. The company with the more effective sales force management receives more dollars of sales per dollar spent on maintaining its sales force than a company with less effective sales force management.

**Anticipating Competitors' Actions**

The anticipation of competitors' actions is a very important consideration in marketing decision-making. Not every firm can be a leader or innovator and, although there are advantages in "leading the pack" or in being first with something new, there are also considerable risks. Indus-

try leaders may gain little differential advantage if their competitors are prepared to follow very quickly, and this advantage may be more than outweighed by possible disadvantages. The failure rate for products that get to the market first is likely to be somewhat higher than for imitations—witness the first ball point pens for instance. So-called “innovations” in the market sometimes prove unacceptable to consumers. Teel liquid dentifrice, introduced by Procter & Gamble in 1948, is an example of an innovation that proved unacceptable to consumers and was removed from the market. Although the management of a business may prefer to leave innovation to others, it must be prepared to imitate successful new products quickly. The firm that fails to anticipate important actions by its competitors risks being caught by surprise when such competitive actions occur, and may lose significant volumes of sales before it succeeds in effecting some counter-action.

#### **FORMULATION OF MARKETING STRATEGY**

Formulating marketing strategy requires careful integration of all dimensions of the marketing plan. Since there are no mathematical formulas to use in designing marketing strategy, marketing management must rely on its own decision-making skills. Ideally, a decision-maker should have some basis for determining whether or not the inputs in the marketing mix (i.e., the combination of marketing decisions) is optimal and, therefore, whether or not the resulting profit or other desired outputs will be optimal. This means that, although mathematical programming is impossible, the approach followed by the decision-maker should be as orderly as possible.

An orderly approach to the design of marketing strategy involves making evaluations of the impact of each decision (on price, product, promotion, etc.) on the firm's marketing situation and its markets. This should help to reduce the margin of error in optimizing the marketing program. Selections should be made from the various marketing inputs (product variables, price variables, distribution channel variables, etc.) so that the combination of inputs going into a particular marketing program will be the best possible to achieve the desired outputs.

#### ***Factors in Selecting Marketing Inputs***

**COMPETITORS' COUNTER-MOVES.** The relative effectiveness of possible counter-moves by competitors varies with different marketing inputs, and this must be taken into account by the decision-maker in selecting inputs. Most competitors, for example, can easily and quickly match or adjust to price changes; however, they often find it difficult (and sometimes impossible) to follow or retaliate against product innovations. This explains why many marketers seek to gain differential advantage



over their competitors by varying product characteristics rather than prices. Gasoline price wars develop because in most cases some independent service station operators fail to evaluate alternative strategies intelligently. Anxious or even desperate to increase volume, an individual retailer will unobtrusively lower prices, hoping that competitors will not notice his action or will not copy it. Of course they do, and the result is the start of a price war. If, instead, the retailer offers superior customer service as his competitive strategy, it may not be copied, and he will gain a competitive advantage. A marketer desiring to improve the "hitting power" of his marketing strategy should give first consideration to those moves involving inputs which are least subject to retaliatory actions by competitors.

**MUTUAL REINFORCEMENT.** Some marketing inputs are mutually reinforcing, and this factor should be taken into account in working toward an optimum marketing strategy. For example, spending a certain sum for point-of-purchase displays carefully designed to tie-in with a national advertising campaign often increases the total impact of a promotional effort far more than an equal number of dollars put into additional advertising. Displays and advertisements can be made mutually reinforcing, since the display repeats the advertising message at a time when the consumer is in an outlet where the product is on sale. Similarly, product policy and distribution-channel policy can be mutually reinforcing or not, depending on the effectiveness with which the two types of policy are integrated. For instance, when a producer distributes his product through self-service retailers, potential buyers should be able to readily identify the product from its package, and to obtain from it information which clerks would otherwise have to provide. When bed sheets are sold in full-service retail stores, they are frequently not packaged. Sales clerks inform the customer as to brand name, thread count, and shrink resistance. But when sheets are sold in self-service stores where the help of sales clerks is not available, individual packaging provides a way of presenting product information to the consumer.

**SUBSTITUTABILITY.** The selection of marketing inputs is also affected by their degree of substitutability. In other words, it is important to know the extent to which one type of input can substitute for another type; inasmuch as the goal of maximizing profits prevents a decision-maker from making unlimited use of all inputs. A marketing strategist must ask himself such questions as these: Will product quality higher than that found in competitive products serve as a substitute for a promotional budget smaller than those of competitors? Will a large promotional budget substitute for shortcomings in dealer cooperation? Will a price lower than those of competitors substitute for sparse distribution?

Consideration of such substitutables helps the marketer determine which input(s) to emphasize in his marketing mix.

#### *Optimum Combination of Marketing Inputs*

**PRODUCTIVITY.** In planning the marketing mix, the decision-maker should remember that not all marketing inputs have equal productivity at various levels of use. Some inputs require a minimum level of use before they begin to have measurable effects—e.g., often an advertising message must be repeated several times before consumers become aware of it. A single spot television commercial may have almost no effect on viewers, but after being repeated several times, viewers begin to “hear,” “see,” and remember it. Thus, in such instances, if the marketer cannot afford a sufficient number of TV spots to succeed in passing the threshold of consumers’ awareness, he might be better off concentrating on some other input where the cost of crossing the threshold of awareness is lower. The lower cost per consumer contact of radio, magazines, and billboards will often make it possible to provide a much stronger impact on consumers than TV can do with a limited budget.

**ECONOMIES OF SCALE.** The choice of a combination of marketing inputs is also affected by economies of scale—i.e., by efficiencies resulting from operating above a minimum level of activity. For instance, a direct-to-retailer distribution channel may offer a producer some strong advantage in terms of communication and promotional effort, and in areas where his retail outlets are geographically concentrated, the cost per salesman’s call may be low enough for direct-to-retailer distribution to be economical. Yet in other areas, where the retail outlets handling his product are widely scattered, the costs of using the direct distribution channel are likely to be out of line with the costs of using alternative channels. In this instance, economies of scale dictate different methods of distribution in the two kinds of areas. Similar economies of scale apply in using many marketing inputs, such as those involving advertising media, adding new items to the product line, servicing products directly or through middlemen, and so on. When possible economies of scale are involved, inputs already at an economical volume will represent the most productive investment of resources.

**INPUT ELASTICITY.** Different marketing inputs vary in their effects on demand, and this should be considered in selecting the best combination of marketing inputs. For instance, a producer may have to make several pricing decisions which apply to a single product, and his choice of the best combination depends partly on his analysis of demand elasticity. Thus, for example, when distributors and dealers generally follow a manufacturer’s suggested prices, the manufacturer, in effect, establishes

selling prices at all three distribution levels. An understanding of variations in price elasticity at each level will help him determine whether increasing wholesalers' and retailers' margins is likely to be more or less effective than decreasing the prices consumers are asked to pay. If the consumer demand for a product is relatively inelastic, a 5 per cent increase in dealer and/or wholesaler margins may be more effective, because of the resulting increase in promotional efforts by these middlemen, than a 5 per cent decrease in prices to consumers. Actually, such decisions are much more complex than the above example implies, since not only must price elasticities be taken into account, but simultaneous comparisons need to be made of promotional and product elasticities. Although it is hard to find an orderly or scientific approach to the job of estimating price, promotional, and product elasticities, it should be tried, for even crude results offer a better alternative than pure intuition.

#### *Implementation of Marketing Strategy and Timing*

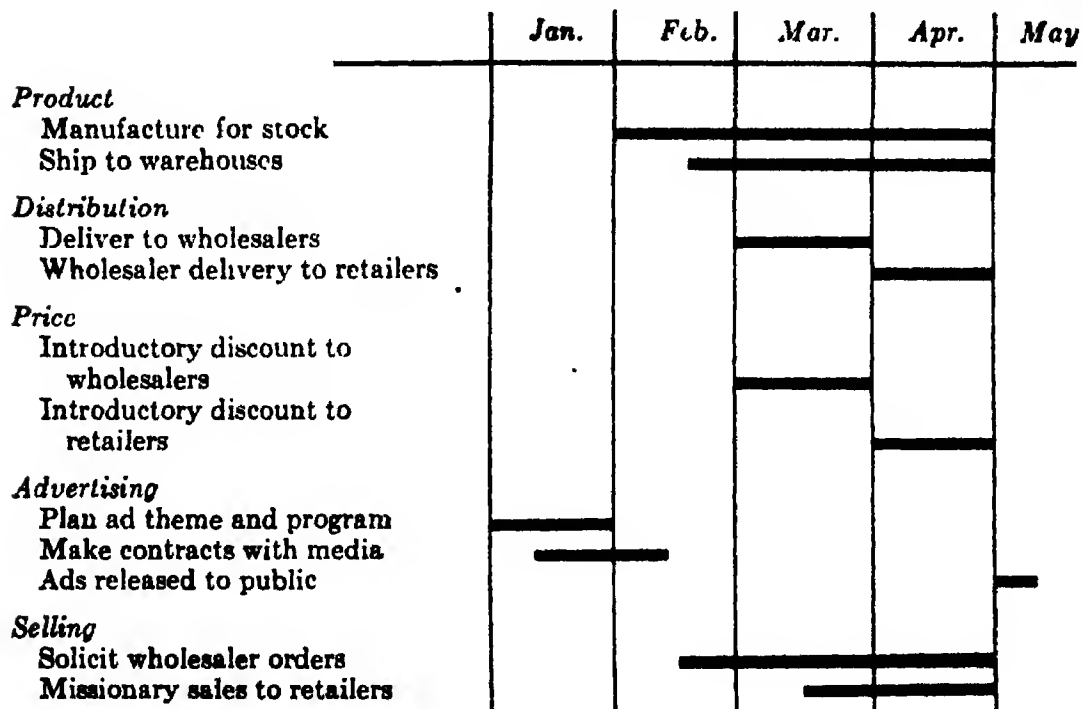
Marketing inputs require different amounts of time to implement, so they must be developed and introduced in some planned sequence that permits the achievement of a particular marketing mix at some given future date. For example, increasing the total size of a sales force involves using several months, perhaps even years, for recruiting and training new men to the point where they become productive salesmen. Setting up a new distribution channel for the product may require even a greater expenditure of time. Network television advertising schedules are often booked a year in advance. Several weeks of repeating an advertising message may be necessary before it begins to have an impact on sales. A successful marketing program requires the careful coordination of all such factors. The importance of coordination in timing is illustrated in Exhibit 21.1, a plan for the introduction of a new product.

All inputs do not retain previously-achieved levels of effectiveness over the same length of time. A new product or package probably will continue to attract buyers up to the time some competitor introduces a better product or package, and such competitive innovations can occur almost at any time. An advertising theme may lose its effectiveness after a single season of use, while another may continue to attract new customers for many years. Thus, the relative rates of decay in effectiveness must be taken into consideration in planning marketing inputs, as you will recall from the analysis of learning theory in Chapter 8.

Because of these factors, management should, in implementing a marketing strategy, establish a logical sequence of events and develop a time table for the introduction and continued application of each marketing input. For example, see Exhibit 21.1. Working back (in time) from the target date, each input must be scheduled with sufficient lead time for it to be fully productive at the target date. If a new-model

typewriter is to be introduced on May 1, dealer orders must be solicited thirty to sixty days before that, and wholesaler orders still earlier, so that the products will be on sale on the target date. The advertising program must be planned and scheduled for release in media on and following May 1. If the advertisements should happen to reach consumers before the new typewriters are available for sale, much of the advertising

**Exhibit 21.1**  
**XYZ Company**  
**Time Schedule for**  
**Introduction of the New Electric Typewriter**



expenditure will probably be wasted, and if the dealers stock the new product long before the advertising is scheduled to appear, they may have difficulty selling the typewriters at first, lose interest in the item, and fail to give it their "best efforts" at the time the advertising finally appears. Only if the dates of product availability and appearance of promotion coincide on or near May 1, will the best results both in terms of advertising productivity and dealer cooperation be obtained. Timing, then, is an extremely important consideration in the implementation of a marketing strategy.

#### **A PROMOTIONAL DECISION GAME**

Business games provide an excellent vehicle for demonstrating the interrelationship of business decisions and the need for coordination between decision areas to achieve optimum results. For this reason, a simple promotional decision game is presented below:

## F. C. MILLER BAKING COMPANY

The F. C. Miller Baking Company, a producer of bread and related bakery products, is located in a Midwestern city of 500,000 population. The company's products, sold under the Grandma Miller brand, are distributed in approximately 60 per cent of the retail food stores in the city and its immediate suburbs. Nearly all of the large supermarkets and chain stores already carry Grandma Miller bread. In addition, Miller bakery products are sold to large institutional buyers, such as restaurants, schools, and hospitals. Major competition in the city comes from three other large bakeries—two independents and a branch of a national chain.

In late December, Jack Miller, the marketing manager, is re-evaluating the over-all promotional program as part of the work involved in completing the January promotional budget. Although the current year has been successful, with a 5 per cent increase in sales over last year, he is uncertain as to whether most effective use is being made of advertising, selling, and other promotional efforts. Net sales will be approximately \$1,100,000 this year and \$95,000 in December. Exhibit 21.2 shows the operating statement for December.

Deliveries and sales are handled by 20 driver-salesmen, who make daily calls on accounts leaving fresh goods and picking up day-old goods. The salesmen average about 30 calls a day, the exact number varying with the density of retail outlets on each route. Each salesman is paid \$500 per month, and it costs an additional \$250 per month on the average (including truck leasing fees, truck operation costs, and other expenses) to keep each salesman on the road. Since expansion through addition of new routes would necessarily be into parts of the trading area with lower densities of retail outlets, it is expected that truck operations costs would be higher on such routes. The cost of hiring and training a new salesman is \$400, and, since the training program lasts two weeks, sales trainees must be included in the budget one month before assigning them to productive routes. When a salesman is discharged, he receives one-half month's (\$250) separation pay.

Advertising has been restricted to the leading local evening newspaper, and Mr. Miller plans to continue concentrating all company advertising in this single medium, since he believes it to be the most economical medium for reaching a maximum number of consumers in the trading area. For the past several years the amount set aside for advertising has approximated 3 per cent of sales, but Jack Miller admits that this percentage is nothing more than a "rule of thumb" used because he has no really reliable information on the productivity of his advertising. F. C. Miller, Jr., nephew of Jack Miller and assistant marketing manager, believes the company's advertising would be more effective if con-

**Exhibit 21.2****F. C. Miller Baking Company***Profit & Loss Statement for the month of December*

Net Sales				\$95,000
Less: Cost of Goods Sold				<u>48,500</u>
Gross Margin				\$46,500
Expenses:				
General & Administrative Expense			\$13,900	
Selling Expense				
Direct Selling				
Sales Salaries	\$10,000			
Other Expense	<u>5,000</u>	\$15,000		
Advertising		4,000		
Marketing Office & Admin.		<u>5,200</u>		
Total Selling Expense			24,200	
Total Expense				<u>38,100</u>
Net Profit on Sales				\$ 8,400

centrated in "large, heavy-impact advertisements," but Jack Miller believes it is wiser to increase the frequency of consumers' exposure to the message through more frequent small advertisements. In fact, Jack suspects a mistake was made three months ago when a change was made from one-eighth page ads inserted daily to one-quarter page ads inserted four times a week. (Exhibit 21.3 shows a schedule of advertising rates.)

**Exhibit 21.3****Advertising Rates—Daily Sentinel**

<i>Frequency of Insertion</i>	<i>Full Page</i>	<i>½ Page</i>	<i>¼ Page</i>	<i>⅛ Page</i>
Once per month	\$ 800	\$ 450	\$ 250	\$ 150
Twice per month	1,600	900	500	300
Once per week	3,200	1,800	1,000	600
Twice per week	6,400	3,600	2,000	1,200
Four times a week	12,800	7,200	4,000	2,400
Daily	22,400	11,700	6,500	3,900

F. C. Jr. has been trying to persuade Jack to authorize an experiment with the point-of-purchase displays in retail outlets as a means of promoting a special "product of the month." He proposes that management select a different product each month for promotion with specially designed banners and displays in retail stores. A recent trade journal article reported that a southern bakery tried this idea with considerable success,

increasing sales by as much as 5 per cent in some months. Banners and special display racks can be purchased at \$10 per installation (for a single store), but for large quantities, unit prices are lower as shown below:

Less than 150 units	\$10.00 per unit
150 to 299 units	9.50 per unit
300 to 499 units	9.00 per unit
500 or more units	8.00 per unit

Display units must be bought in quantities divisible by 25 up to a total quantity of 150, and above that in quantities divisible by 50. Since these materials are designed for special thirty-day promotions, their costs must be amortized in the month used. The Miller Co. classifies the retail outlets it serves into five categories and has analyzed their sales of Miller products as shown in Exhibit 21.4. F. C. Miller, Jr. believes these displays should be set up in *every* retail outlet, but Jack Miller is skeptical of the whole idea.

**Exhibit 21.4**  
Retail Outlets in Bigsville and Environs

<i>Classification</i>	<i>Number Now Served by Miller Company</i>	<i>Average Monthly Sale of Miller Products</i>
Class A—Large supermarkets	25	\$1,260
Class B—Medium supermarkets	50	360
Class C—Small supermarkets	75	180
Class D—Traditional chain outlets	150	90
Class E—Neighborhood "Superettes"	300	45

Because of the illness of Jack Miller, you have agreed to assume the duties of marketing manager for an indefinite period. Your immediate task is to prepare the promotional plan and budget for the coming month.

#### *Instructions to the Players*

Think what your objectives should be and plan your decision accordingly. The official referee will tell you how many decisions will be made by each team. Remember, each team will be competing against its own record from month to month, not for a share of the total market.

For each month the game is to be played, each player or team should have a "Management Decisions" sheet (Form 1) and a blank Profit and Loss Statement (Form 2)

Decisions should be made on the sales force, advertising, and point-of-purchase displays. Form 1 should be filled in as follows:

1. Determine the total number of salesmen you want to have at the beginning and end of the month and record the number of trainees

who must be hired *or* salesmen who must be dismissed to achieve these figures. Add trainees to be assigned to routes (if there are any) and compute the net productive sales force for the coming month. Compute and record planned sales salaries and, where appropriate, costs of sales training and salesman separations. Leave "Other Selling Expense" blank; official scorer will determine and fill in this amount.

2. Decide upon and record the size and frequency of insertion of ads desired in the coming month. From Exhibit 21.3 determine and record the budgeted amount for Advertising Expense for the coming month.
3. If you decide to use point-of-purchase displays, determine the number of stores you wish to service, calculate the cost, and record. The displays you purchase will be placed in the largest stores first, and then in each next lower size category as long as the quantity purchased lasts.

Hand in Form 1 to the official scorer. He will determine and record other Selling Expense, Sales, and Cost of Goods Sold and return the form to you.

### Form 1

#### Management Decisions

Month being planned \_\_\_\_\_

Team # \_\_\_\_\_

#### 1. Sales Force

##### A. Productive sales personnel

Number of salesmen (current month)	_____
Add: Last month's trainees to be assigned to productive routes	_____
	+ _____
Less: Dismissals	_____
Net sales force (coming month)	_____

##### B. Number of trainees to be hired this month

\_\_\_\_\_

##### C. Direct selling expenses:

Salesmen training (new trainees × \$400)	_____
Salesmen separations (dismissals × \$250)	_____
Sales salaries (no. of productive salesmen × \$500)	_____
Other selling expenses (to be filled in by scorer)	_____

#### 2. Advertising

Proposed size of advertisements	_____
Proposed frequency of insertion	_____
Budgeted advertising expense (see Exhibit 21.3)	_____

#### 3. Point-of-purchase displays

Number of display units purchased \_\_\_\_\_ cost \_\_\_\_\_

4. Sales for the month \_\_\_\_\_ } To be filled in by scorer
- Cost of goods sold \_\_\_\_\_ }



**Form 2***Profit & Loss Statement for the period* \_\_\_\_\_*Team #* \_\_\_\_\_

Net Sales			_____
Cost of Goods Sold			_____
Gross Margin			_____
Expenses			
General & Administrative Expenses			<u>\$13,900</u>
Selling Expense			
Direct Selling			
Salaries	_____		
Other Sales Expenses	_____		
Training	_____		
Separations	_____		
Advertising		_____	
Displays		_____	
Marketing Office & Admin.		<u>\$5,200</u>	
Total Selling Expense			_____
Total Expense			_____
Net Profit on Sales			_____

When the completed Form 1 is returned to you, prepare a Profit and Loss Statement (Form 2). After analyzing financial aspects of your operations, plan and make your decisions for the following month.

**CONCLUSION**

In this chapter we have suggested an orderly approach to the planning and implementation of marketing strategies. We believe that it is more logical to approach the formulation of marketing strategy in as formal a way as possible, even though there are no planning models that can be applied to this problem with high precision, than it is to resort to a completely informal, unstructured approach. Strategy, by definition, is a competitive activity, and it involves developing a marketing mix which will reflect the expected actions and counteractions of competitors. The promotional decision game serves to illustrate the difficulties of optimizing only a very limited number of inputs with other inputs even when the competitive environment is held constant.

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